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# EDUCATION TAX PROPOSALS

## HEARING

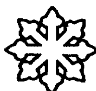
BEFORE THE

## COMMITTEE ON FINANCE
## UNITED STATES SENATE

ONE HUNDRED FIFTH CONGRESS

FIRST SESSION

APRIL 16, 1997



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# EDUCATION TAX PROPOSALS*

**WEDNESDAY, APRIL 16, 1997**

U.S. SENATE,
COMMITTEE ON FINANCE,
*Washington, DC.*

The hearing was convened, pursuant to recess, at 10:03 a.m., in room SD-215, Dirksen Senate Office Building, Hon. William V. Roth, Jr. (chairman of the committee) presiding.

Also present: Senators D'Amato, Nickles, Mack, Moynihan, Conrad, Graham, Moseley-Braun, Bryan, and Kerrey.

## OPENING STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM DELAWARE, CHAIRMAN, COMMITTEE ON FINANCE

The CHAIRMAN. The committee will please be in order. When it comes to the well-being of our youth, few things are as important as quality education, likewise when it comes to the future of America.

Never has education been more important than now, a time when technology is so accessible, a time when potential is without limits, and a time when the event of a global economy demands the best we have to offer.

It is through education that young people more fully develop their concepts of citizenship, social responsibility, patriotic determination, or, as Jefferson would say, their "rights, interests and duties as citizens."

Certainly parents and communities play instrumental roles, but education is the formal component in this important process. Education creates productive adults, men and women who are well-trained, thoughtful, analytical, and ready to discharge their duties to family, community and Nation.

Education at the collegiate level that our society recognizes it economically. The economic distinction is growing. Today, a college graduate earns 60 percent more than a high school graduate. In 1980, the difference was 30 percent. In other words, the need for a college degree for economic reasons alone continues to grow.

Dangerously outracing the increase in earning potential of a college education, however, is the increasing cost of earning a college degree in the first place. Between 1980 and 1995, the tuition at a 4-year public college increased 234 percent. At the same time, me-

*For further information on this subject *see also,* Joint Committee on Taxation committee print JCS-9-97—*"Analysis of Proposed Tax and Savings Incentives for Higher Education,"* April 15, 1997.

dian household income rose just 82 percent, and the consumer price index rose 74 percent.

This is leading to alarming levels of debt for our young people. I was astonished to see that the average debt for medical school is over $90,000, or dental school, $75,000, for law school, $40,000, and for the undergraduate, is over $10,000. This is a problem for families at almost all income levels.

Today we will hear how this huge debt affects men and women as they leave college and begin careers and families. We will hear about several proposals that could help alleviate such a burden.

I will be listening to these proposals, proposals that I hope will focus on improving economic access to education without inflation the cost of tuition. For many years I have been an advocate of providing tax incentives for savings, savings that could be used without penalty to pay for education. I am still actively working on this, hoping to broaden and expand Individual Retirement Accounts.

I am also pleased to be a proponent of S. 1, the Safe and Affordable Schools Act. This bill helps parents set aside necessary resources to pay for these children's tuition.

It makes the interest on student loans tax-deductible and it gives favorable tax treatment to State prepaid tuition plans, to education aid provided by an employer, and to student work study awards. Expanding IRAs and the provisions in S. 1 are the kinds of innovative approaches we need to meet the needs of our students. Today I look forward to hearing more about these and other innovative proposals.

Our first statement will be from Senator Coverdell. It is always a pleasure to welcome you here, Paul. I know that you are the leader of the Republican Education Task Force. I know of your commitment to making college education more affordable.

We are asking the opening statements to be limited to 3–5 minutes, and we would appreciate it if our colleagues would do that.

Senator Coverdell, would you please begin.

## STATEMENT OF HON. PAUL COVERDELL, A U.S. SENATOR FROM GEORGIA

Senator COVERDELL. Well, thank you, Chairman Roth, Senator D'Amato. I appreciate the opportunity to come before your committee and visit for a moment about S. 1.

As you know, Mr. Chairman, S. 1 is a leadership proposal, the product of long work at our conference. I want to underscore that much of it reflects the Chairman's work.

You alluded to that in your opening statement, but I think, perhaps, understated the work that you have done and your efforts to make college education more affordable and to build a plan for families to prepare for those costs. Your fingerprints are all over S. 1, and we appreciate that very, very much.

The CHAIRMAN. Thank you.

Senator COVERDELL. I think it is important to make the statement that S. 1 recognizes the appropriate relationship between the Federal Government and the State governments. There is nothing in S. 1 that can be construed to be a mandate, an edict, an instruction or order. It envisions the educational relationship between the

Federal Government and the local governments as one of a partnership.

If I might take just a moment, I think one of the essential tenets of American freedom is founded on an educated people. I do not believe there are an uneducated people who are free, or who will remain free.

The current situation in K–12: 40 percent of the students that went to school today are frightened, 20 percent of them carried a weapon, 2,000 acts of violence will occur in American classrooms per hour today, and no one could characterize that as a learning environment. S. 1 endeavors to begin to come to terms with that.

Just, if I might briefly frame the scope of the bill, it does establish pilot programs that allow local communities and local educational districts, to deal with the establishment of drug-free, violence-free schools. It also allows for experiments that help families escape environments that are certifiably violent.

It provides incentives for schools to make their school and classroom safer. It deals with the overpowering mandate for special education passed by the Federal Government in the 1970's, but never funded, which has impounded the flexibility of local school districts to deal with their priorities.

It has provisions that deal with the cost of education, which I will return to in a moment, and it offers incentives for literacy efforts and adult education.

With regard to the provisions for affordable education, I think one of the major distinctions between S. 1, the Congressional educational initiative, and the administration's, is that S. 1 is framed to plan for the future, whereas the majority of the effect of the administration's proposal is to deal with contemporary costs and, in fact, concludes the advantages that it offers, in the year 2001. So the scope of the financial differences are, one, designed to prepare families for the future, and the other deals with families that already have their children in higher education.

Quickly, it establishes the Bob Dole Education Investment Account, which allows a family, after tax, to save $1,000 per year with the money coming out of that account for educational purposes at age 18 for the child.

It provides a $2,500 per year tax deduction for interest paid on student loans for the first 5 years of repayment. It changes current law to allow funds disbursed from a prepaid State tuition plan to be tax-free to the student, and allows disbursements to cover room and board expenses, not merely tuition.

It provides employer-provided educational assistance, encouraging employers to offer continuing education as a benefit to their employees and increases he value of Federal work study awards by making them non-taxable to the student.

I am about to conclude and try to adhere to your 5-minute admonishment. We have a HOPE scholarship in my State, and you must have had a "B" in high school to receive it and maintain it. The President envisions a "B" grade.

I understand the incentive nature of that, but get a little worried about the family that is struggling with the student who just naturally is not a "B" student, and I do not know that that such a family should be punished.

Just as a matter of thought for the committee, I am concerned about tuition inflation, particularly when a program is so short-lived, it almost invites it. As I said, the big distinction here is planning for the future or rewarding contemporary activity. We do have some suggestions that we will leave with the committee that expand S. 1.

We have questioned ourselves as to whether S. 1's financial reward should only be associated with higher education or whether we should not offer broader flexibility.

I always am troubled by legislation that gives tax relief based on you doing something we think you should do versus allowing the family more options and flexibility to deal with that with which they think they need.

So we will leave these suggestions with the committee for its further review. I would ask the committee, knowing there are extensive discussions with regard to tax incentives, relief, and planning related to higher education, that as the managers of S. 1, we have an opportunity to interact with the committee in its discussions in that arena.

I thank the Chairman very much for the opportunity to give this brief summary of S. 1 and its tax incentives, and we will leave the newer ideas with you in written form.

The CHAIRMAN. We appreciate that very much, Senator Coverdell, and we assure you we look forward to continued working with you as this legislation develops. Thank you very much.

Senator COVERDELL. Thank you, Mr. Chairman.

[The prepared statement of Senator Coverdell appears in the appendix.]

The CHAIRMAN. Our next statements will be from Senator Graham from Florida, a distinguished member of our panel, as well as Senator McConnell from Kentucky. I know both of these gentlemen, how committed you have been to the development of prepaid tuition and qualified State-sponsored savings plans. So we look forward to hearing from each of you.

Senator Graham, will you please commence.

## OPENING STATEMENT OF HON. BOB GRAHAM, A U.S. SENATOR FROM FLORIDA

Senator GRAHAM. Thank you very much, Mr. Chairman and members of the Finance Committee. I read the sign which says please limit your testimony today to 5 minutes. I assume you are very committed to that timeliness.

The CHAIRMAN. Absolutely.

Senator GRAHAM. So I will ask that my full statement be entered in the record, and let me summarize.

The CHAIRMAN. Without objection.

[The prepared statement of Senator Graham appears in the appendix.]

Senator GRAHAM. Mr. Chairman, Florida was the second State to establish a prepaid college tuition program. The reasons that we began considering this while I was Governor in the mid-1980's were essentially the same that caused now 19 States to develop a prepaid college tuition program, and that was that the cost of attending college was rising at a rate considerably faster than the

cost of living, or other indicators of inflation. This was making it increasingly difficult for many families to reasonably expect that they could finance the cost of their children's education.

So the concept of the prepaid college tuition plan was that parents would enter voluntarily into a contractual relationship with a State agency which would guarantee them that, for a stipulated amount of money which could be paid either monthly, annually, or in one lump sum, they would have a guarantee of 120 credit hours at a State community college or university when their child reached, and assuming their child was eligible for admission to that institution. That is the basic structure of the plan.

Today, approximately 12 years later, there are 426,000 contracts in place in Florida. One out of every 9 children under the age of 18 in Florida has a contract for their higher education purchase through the prepaid plan. There are $1.4 billion in assets in the plan.

One of the most interesting aspects of this is who purchases these contracts. I would like to ask if we could put up two charts. Well, I guess it is one chart that has two pieces of information.

The left circle represents the distribution of all university students in our State based on average income of family. The pink and red represent those families which have incomes of over $50,000 a year, the green represents those with family incomes of under $50,000 a year.

There had been some concern that the prepaid college plans would be largely utilized by more affluent families. In fact, a dozen years of experience has indicated that the profile of the purchasers of the prepaid college plans is different than the overall profile of college attendees, but it is skewed towards those families with incomes of less than $50,000.

So the prepaid college plan has become a means by which middle and lower income Florida families are able to provide for the education of their children. Forty thousand Florida contracts, in fact, or almost 10 percent of the total have been purchased by families who have incomes below the poverty level, which is a strong statement of those families' commitment to their children's future.

I would like to introduce two of the students who have benefitted by the Florida prepaid tuition plan, Sean and Patrick Gilliland of Bradenton, Florida. Would Sean and Patrick please stand.

Senator MOYNIHAN. Good morning.

The CHAIRMAN. Nice to have you here.

Senator GRAHAM. Sean and Patrick are both students at the University of Florida. Sean will graduate in two weeks with a degree in business, with the intention of pursuing a career in international finance. Patrick will graduate next year with a degree in exercise science, with the expectation of pursuing a master's degree in cardiovascular rehabilitation.

Neither of these two young men would have had the opportunity, or certainly not the opportunity with the ability to focus as fully as they have on their academic careers, but for the fact that their family purchased a prepaid college tuition contract for them.

Unfortunately, their father passed away while Patrick was still in high school and Sean had just started his college career, so the

availability of the funding through the prepaid college tuition plan has been critical to their academic career.

Just let me briefly summarize what I think are some of the reasons why it is appropriate for this committee to expand on what occurred in 1996. In 1996, the Congress voted to eliminate the taxability of the build-up of prepaid college plans, but deferred the issue of the taxation at the time that the fund purchases the 120 credits from the academic institution.

The legislation that Senator McConnell, myself, and as of today an additional 15 members of the Senate will be introducing today would eliminate the taxability at the time of purchase of the 120 credit hours. We believe that this is appropriate, for several reasons.

It encourages, recognizes and supports State innovation in meeting what is clearly a national challenge, and that is to reduce economic barriers to higher education.

It encourages savings. In my own State alone, almost $1.5 billion has been added to the saving pool of America as a result of this program. It assists students like Sean and Patrick in being able to attend college.

Finally, it puts downward pressure on tuition by the State, committing that it is going to sell 120 credit hours of education at a stipulated price. It creates a pressure for efficiency within higher education and moderation of tuition rates.

So, Mr. Chairman and members of the committee, I submit to you that this is a very powerful idea which now some 19 States have adopted, another 25 or so States are seriously considering, that it meets both State and national goals, and that removing the final cloud of taxability at the time of distribution would be very constructive and would contribute to the further expansion of this important idea.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator McConnell.

## STATEMENT OF HON. MITCH McCONNELL, A U.S. SENATOR FROM KENTUCKY

Senator MCCONNELL. Thank you, Mr. Chairman. I have enjoyed working with Senator Graham on this issue, both in the previous Congress and in this one.

I assume many of you may have seen, I think it was, Time magazine a few weeks ago, a shocking front page story which analyzed the increase in tuition costs at one particular university, which is apparently duplicated and reflected in the statistics across the country.

In short, tuition has gone up a staggering amount in the last 20 years. The question that we are grappling with here, all of us, is how best to get at that problem. Senator Graham alluded to one of the fears that many of us have with regard to an approach similar to the one the President is suggesting with regard to tax credits or deductions, that it may, in fact, just feed the hyperinflation that is already going on on college campuses.

The beauty of the savings account approach that we will be introducing later today, is that it clearly puts pressures on colleges to

keep tuition increases to a minimum, rather than just the opposite. In addition to that, it keeps this decision in the hands of parents. I think it is also encouraging, the statistics that Bob pointed out a while ago, that lower income people will, in fact, take advantage of this opportunity.

The rising cost of education produces for more and more families reliance on financial aid, as we all know, to meet tuition costs. In fact, a majority of all college students accept some amount of financial assistance.

Disturbingly, increasingly loans make up a larger portion of the Federal aid pie, at 57 percent, and grants have been reduced to 42 percent. This shift toward loans further burdens students and families with additional interest costs, as we all know, down the road.

In response to this, we are all trying to figure out what the best way to grapple with this problem is. Paul Coverdell just covered S. 1 and its provisions in this regard, and Bob Graham mentioned that there are 15 States with programs in operation, and another 4 that are likely to go to these State-sponsored tuition savings programs in the course of the next year.

In terms of the number of people currently participating in these State-sponsored plans, there are about 600,000, contributing over $3 billion to education savings nationwide. By year-end, the college savings plan network estimates that they will have one million participants. By 2006, they estimate over $6 billion will be invested in State-sponsored programs.

In my State, for example, there are 2,600 participants who have contributed over $5 million, and, listen to this, on average, $49 a month being put aside to make sure they can educate their children.

Last year, Congress took the first step in providing tax relief to families investing in these programs. The provision is contained in the Small Business Job Protection Act, which Bob and I worked on, and you, Mr. Chairman, as well, and clarified the tax treatment of both State-sponsored tuition plans and the participants' investment.

This measure put an end to the tax uncertainty that has hampered the effectiveness of these State-sponsored programs and helped families who were trying to save for their children's education.

Now, today Senator Graham and I will be introducing a standalone bill, with the support of a number of others, to take it a step further and to exempt from taxation the benefits from these savings programs. This legislation is a serious effort to encourage long-term savings.

It is important that we not forget that compound interest cuts both ways. By saving, participants can keep pace with tuition increases by putting a little away at a time. By borrowing, students must bear added interest costs that add thousands to the total cost of tuition.

It is in our best interests as a Nation to maintain a quality and affordable educational system for everyone. We need to decide how we will spend our limited Federal resources to ensure that both access and quality are maintained.

It is unrealistic to assume that the government can afford to provide Federal assistance for everyone. We do not have the money. However, at a modest cost we can help families help themselves, by rewarding savings. That is what this bill is about. It will reduce the cost of education and it will not unnecessarily burden future generations.

Senator Graham and I believe this is the most prudent approach, to adopt the tax credits contained in S. 1 and boost need-based grant funding in particular grant funds that target low-income families who will benefit, frankly, very much from the President's proposal, and give this additional savings opportunity to all Americans.

Mr. Chairman, I would like to ask that my entire statement be made a part of the record, and I appreciate very much the chance to be here.

The CHAIRMAN. Without objection.

[The prepared statement of Senator McConnell appears in the appendix.]

The CHAIRMAN. Thank you, gentlemen, very much for being here today. It is a very important, innovative proposal, and one that we look forward to working with you on. Thank you very much.

It is now my great pleasure to call upon my junior colleague from the first State, the State of Delaware. Senator Biden, will you please begin?

## STATEMENT OF HON. JOSEPH R. BIDEN, A U.S. SENATOR FROM DELAWARE

Senator BIDEN. Thank you, Mr. Chairman. It is a pleasure to be here. The way I look at it, if a Democrat cannot be Chairman, I would like a Senator from Delaware to be Chairman, and I am delighted you are.

Mr. Chairman, I will be necessarily brief. Let me begin by suggesting that there is a lot of redundancy in what you are going to hear today, and that is good news. It is good news, because it seems like the entire Congress is focused on, and understands, that we have a real problem. That is, the ticket to the American dream is through the front door of a college.

What was a necessary ticket for admission to ride when I graduated from high school was a high school diploma. You could get by. You could have an income that, in fact, allowed you to live a middle class existence. But, quite frankly, with notable exceptions of particularly gifted entrepreneurs, it is unlikely that you will be able to live that middle class existence absent a college education.

Second, I think it is worth noting that, as bad a shape as our education system is in, there is no better system in the world than our higher education system. So, people understand that as well. Not only does the whole world beat a path to our door to higher education, but an awful lot of Americans are having that path blocked to the door. They have great difficulty in getting there.

My good friend from New York, Senator D'Amato and I, and we are friends, our sons were college roommates in undergraduate school, and then different sons were law school roommates. We understand, as all of you do up there, the cost, and we make a good income. We do very well.

When I was in college, my parents could send me to the State university that I attended, the University of Delaware, for less than 5 percent of their income because they were middle to lower middle class in terms of the way we categorize incomes. But, for 5 percent of their income, which was a sacrifice, they could send me to college. I always get a kick out of guys my age who walk around and say, I worked my way through school.

Well, yes, you worked your way through school. The minimum wage was $1.25 an hour and it cost $375 a semester at the University of Delaware and most other universities. If you worked hard and got a little bit of help, you could work your way through.

Try working your way through Georgetown, Penn, or some private institution. You cannot even think about that as a practical matter, unless you are dealing drugs or something. You can work your way through that way, but other than that there is no way you can work your way to make enough money to get through any private institution, but you have a shot at a State institution.

It stayed that way, 5 percent, until the year 1980. But since then, as has been pointed out by other witnesses, the cost has exploded. The cost of public tuition and fees has increased, as the chart indicates over there—Mr. Chairman, I am not telling any of you anything you do not know, but it is worth repeating, I think—it has increased nearly 3 times faster than the average family's income.

Today it takes almost 9 percent of a typical family income to pay for tuition and fees in the public colleges, and 36 percent of their income to pay for the cost of a private college education.

We can debate endlessly the reasons why, who, or what is to blame. But all that middle class families know is, the costs have skyrocketed and they constantly worry about how they will ever be able to afford to send their kids to college.

To address this, I and many others have come up with approaches. Mine is slightly different. But I have introduced a bill that is pending before the Finance Committee, S. 218, referred to as the GET AHEAD Act, which stands for Growing the Economy for Tomorrow, Assuring Higher Education is Affordable and Dependable. My bill addresses the rapidly rising cost of college with a three-pronged approach. Some are very similar to others introduced.

One prong is to provide direct tax incentives for college education. The second prong would award merit scholarship to those who finish in the top 5 percent of their graduating high school classes. The third prong is subject to this hearing today, creating incentives for families to save for college.

There are three ways in which I would encourage savings. First, we should allow penalty-free withdrawals from Individual Retirement Accounts, of which you are the father of, Individual Retirement Accounts, and you educated me about this about 15 years ago, and for those funds that are used to pay for college tuition.

I might point out to Senator Moynihan, you notice I was introduced as the junior Senator. I am the second most senior junior Senator in the history of America. Only Senator Hollings is more junior to his senior Senator than I am. But I have learned much from my senior colleague.

Second, it seems to me we should make more families eligible to use the existing Series EE U.S. savings bonds, under which interest on the bonds is not taxable if it is used to pay for college.

Third, we should create tax-free education savings accounts. Under my plan, middle class families could put up to $2,000 per child each year into an ESA, and this would be tax-deductible and the interest would be tax-free as long as the money is used to pay for the cost of college.

I am pleased to see that the Senate Republican leadership included something very similar to this ESA proposal from the plan I introduced last year. The bill introduced this year is S. 1.

Although there are some differences, I look forward to working with you, Mr. Chairman, and other members of this committee in the only thing we have found that works around here, bipartisan solutions.

I know that many observers have viewed the education savings account idea contained in the Republican leadership bill as an alternative to President Clinton's proposal, and that was mentioned by our distinguished colleague from Kentucky. The President's proposal includes a $10,000 tax deduction. Some see it as one or the other. I think that is unfortunate.

I speak only for myself, but I believe that we should do both because there is not one single answer to the problem that middle class families face with the cost of college, and there is not a Republican or a Democratic answer. We need to do many things, Mr. Chairman, in my view, and providing incentives for college savings is one part of the solution.

Again, I look forward to working with you and members of this committee in a bipartisan fashion to give some relief to families to send their kids to college.

The CHAIRMAN. Thank you, Joe, for being here.

Senator BIDEN. One last point I would make. Sean is still here. Sean, if you want a job in international finance, this is the place to apply, these guys right here. I would start with Senator Mack, not Senator Graham. He is a little tighter. [Laughter.]

But, anyway, thank you very much.

The CHAIRMAN. Thank you, Senator Biden.

The CHAIRMAN. Next, we will hear from Hon. Lawrence Summers, who of course is Deputy Secretary of the Treasury. We are always pleased to have you here, Mr. Secretary. We look forward to hearing the administration's view. Your full statement will be included as if read.

Please proceed.

## STATEMENT OF HON. LAWRENCE H. SUMMERS, DEPUTY SECRETARY OF THE TREASURY, WASHINGTON, DC

Secretary SUMMERS. Thank you very much, Mr. Chairman. I am pleased to have an opportunity to return to this committee to discuss the higher education tax incentives in the President's fiscal year budget.

Providing all Americans with access to higher education is a major focus in the President's budget and it is a goal that we be-

lieve can be achieved as part of a plan to balance the budget by fiscal year 2002.

We are grateful that this committee has chosen to devote this hearing to education issues, and look forward to working with the committee to renew, through the tax system, Federal support for higher education.

Last month, Secretary Rubin and Secretary Riley transmitted the Hope and Opportunity for Postsecondary Education Act of 1997 called the HOPE Act. It contains higher education proposals from the President's budget, including tax incentives which have received the support of the American Council on Education, as well as the presidents and trustees of nearly 400 colleges and universities.

Why is this legislation so important? Higher education pays off and it pays off evermore. In 1979, full-time male workers age 25 and over with at least a bachelor's degree earned, on average, 49 percent more per year than did comparable workers with only a high school degree. That 49 percent difference in 1979 had risen to 89 percent by 1993, suggesting that, for society as a whole, the return to extra education has increased very substantially.

This says something about the importance of this, that the poverty rate for high school graduates with no college education in 1995 was nearly 3 and one-third times as large as the poverty rate for those who had had an opportunity to get a college education.

Reducing the after-tax cost of education will encourage investment in education and training, while at the same time lowering tax burdens for middle income taxpayers. One assumes the objective of middle class tax relief. What better time than when families face the financial strain of sending their children to college, what better way than to support an activity that is not just in families' own interests, but is also very much in our National interest of having a more broadly educated population?

The administration's legislation contains five proposals that have a total cost of $36.2 billion between 1997 and 2000. It is part of a package that also includes increases in the maximum Pell grant. The five incentives are the HOPE scholarship tax credit, a non-refundable tax credit of up to $1,500 per year to cover tuition and fees for at least half-time enrollment in the first two academic years of a degree or certificate program. That program does require a B-grade point average in the first year of college.

Second, as an alternative and to support up to 4 years of education, families would get a deduction of up to $10,000 per year for tuition and fees of students enrolled at least half-time in a degree or certificate program, or for courses to improve job skills. I emphasize that taxpayers do not have to itemize to claim this deduction.

Third, the administration would, and I think this committee has recognized, I think, the importance of this over time, extend both the Section 127 provisions for undergraduate and graduate level assistance through December 31, 2000.

Fourth, the administration's proposals call for allowing small businesses a 10 percent income tax credit for payments under an employer-provided educational assistance program to help them provide increased educational opportunities and work force training for their employees.

Fifth, and frankly this is a provision that, while it is small in revenue costs, seems to me to be a particularly wise one, we would expand the tax-free treatment for forgiveness of student loans.

This refers to the issue of students who receive a loan which is conditioned on relief in the event they go into public service or they work as doctors in a depressed area, and so forth.

Under current law when those students have the loan forgiven, loan forgiveness constitutes income and they have an income tax liability. That subverts the intent of the program and it seems to me to be a small, but important, change that we should make in the Tax Code.

These programs together will make 14 years of education a norm for all Americans who are able to absorb that much education. We expect that they will help some 12.3 million students in 1998 alone.

Let me just say that I share, particularly as one who was involved in higher education, what I think is the very widespread concern about excessive increases in tuition costs. But I am convinced that this program, because it preserves competition between colleges, because for all colleges that are charging more than $1,500 there will still be a very high degree of competition, it is likely to be like other Federal student assistance programs, which evidence shows have not been contributors to the process of inflation and tuition, serious as that problem is.

If I might make just one final observation, Mr. Chairman. I have emphasized in my remarks our assistance for college education. In conjunction with the administration's IRA proposals which I had an opportunity to testify on just a couple of weeks ago before this committee, these provisions constitute the right kind of incentive for people to save for college.

Individuals can make a contribution to an IRA and that contribution is tax-deductible. When the money is withdrawn from the IRA for college, there is no penalty under the administration's proposal, and, up to $10,000, a deduction can be taken for the contribution, which eliminates the tax on that income in the IRA.

We have worked out examples for a family that is saving over time to send a certain amount each year, to send a child to college. While it depends on the exact situation, the reduction in the amount that you have to contribute can easily be 39 percent or more per year, so you are making the process of saving to send your kids to college a far more affordable one.

Finally, Mr. Chairman, increasing access to education, almost uniquely among the tools of economic policy, serves our two fundamental objectives. It both promotes economic growth and a more rapidly growing and prosperous economy and it assures that more people have an opportunity to share in that prosperity and gives us an opportunity to make sure that our prosperity is a more inclusive one, which is the other concern that we have to face as we plot domestic economic strategy going forward.

Thank you very much.

[The prepared statement of Secretary Summers appears in the appendix.]

The CHAIRMAN. Thank you very much, Mr. Secretary. Let me start off by saying that I think there is a lot in common with the

administration, in that we all recognize we have a serious problem that we need to address.

I have to say that I have considerable concern about the question of whether or not the HOPE scholarship tuition tax credit, as well as a $10,000 education and job training deduction would cause inflation.

You have indicated in your opening testimony you did not think so, but we have all seen what has happened in the past. I am sure you are familiar with the recent Time magazine, which deals at great length on the problem of inflation and education. I think it has gone up something like 234 percent in the last 15 years, whereas family income has only gone up 82 percent.

So it is a serious problem and competition, in the past, at least, has not prevented it from taking place. My understanding is that the colleges are pretty good at knowing the financial resources and you have a plan like the HOPE or the $10,000, and that will be taken into consideration as they decide what a student should get in help from the school.

So, even if they do not raise the cost of tuition, it may not benefit the student because the student will find that the college will deny other benefits or other programs. So, I have some genuine concern. What we are out to do is to help the student and make sure that our young people have the opportunity of education. It is not a benefit for the educational institution, basically.

Let me put it this way: the primary purpose is for the student. But I fear that we will end up that the principal beneficiary could be the institution. Would you care to comment?

Secretary SUMMERS. I think you raise a very, very important issue. I think that the whole question of higher education inflation is a serious one and people who are expert in that topic have addressed it, and it goes to a number of things, ranging from the proliferation of administrators to what has happened over time to faculty teaching loads, to some of the basic phenomena that Senator Moynihan has talked about in the past involving services where productivity does not inherently rise at a rapid rate in a growing economy.

So I would not want to tell you that these policies are the answer to the problem of higher education inflation, except in the sense that they are an answer for families because they make education more affordable.

But we have given a great deal of thought to the question of whether they risk exacerbating higher education inflation or undermining student financial aid programs. I think to think about that question you have to distinguish between different types of institutions.

There are a certain number of institutions that have tuitions that are under $1,000 or close to $1,000, where the tuition is low relative to the costs of running the institution, where inflation has probably been a good deal less pronounced than in higher education generally, and where typically they are not in a position to provide very large financial aid awards.

For those institutions I think it is hard to see, because the financial aid is not a large part of what goes on, that there would be very large adjustments. The second category of institutions are in-

stitutions like large public universities in many States, where the tuition is well above the $1,500 limit, so the only issue is the deduction that the family would get. There the question you have to ask, given that most of those institutions in this era are under pressure to attract students, is whether their ability to raise costs or reduce financial assistance awards would be influenced by the knowledge that families were going to get a little bit of support for bearing these costs.

The third class of institutions is obviously the relatively small number of very expensive, very selective institutions, and I think it is unlikely that for those institutions where the dominant consideration in tuition is frankly the overall costs of running the place, including research costs and the like, that the impact would be very great.

So I would give the higher priority to the objective of ensuring that given that these costs have risen, families have a chance to pay for higher education and get this form of assistance.

But certainly as a country I think we have got to look at this problem of higher education inflation, but I do not think it is a reason, any more than medical care inflation is a reason not to support assistance for people to get medical care, to avoid providing support for students who want to go to college and would not otherwise be able to afford it.

The CHAIRMAN. I have a couple of more questions I want to ask you, which I will proceed with. I would appreciate it if you would be as brief as you can.

Secretary SUMMERS. Certainly.

The CHAIRMAN. In your testimony, you cite the Georgia HOPE scholarship tuition tax credit as the model you sought to follow. But, in fact, as I understand it, the Georgia HOPE scholarship program is quite different. It is a scholarship which provides immediate tuition relief to students.

The Georgia scholarship is not subject to any kind of income limits. Students receive the scholarship regardless of the type of Federal grants that the student receives, and it is funded by the State lottery. So I am not certain that the so-called HOPE scholarship really is helpful in determining what are the tax consequences of the administration's proposal. Would you care to comment?

Secretary SUMMERS. The situation is different at the Federal level, Mr. Chairman, but I think the basic essence of it, which is that the 13th and 14th grade are paid for by the government if you are in good standing. That is the basic essence of the HOPE scholarship in Georgia. That is the basic essence of this program.

It is true that reflecting budget realities and the desirability of targeting, that a couple percent of families that are not eligible for this, but it is a very small fraction of families that would be above the income limit for this. It is true that the financing source is different.

This is part of our overall budget rather than having a dedicated source like the lottery. But the basic model of what this does to encourage kids to go on to school, I think, is fundamentally the same in the United States in this Federal program as in the Georgia program.

The CHAIRMAN. The only point I was really trying to make, of course, is that I think you cannot use one as precedent for the tax consequences for the other.

Let me go on to the question of eligibility. It is my understanding that the Georgia HOPE scholarship program was recently modified to maintain a B average in certain core curriculum.

A study found that 44 percent of the students who received the Georgia HOPE scholarship would not have received the scholarship had the program been based on the students maintaining a B average in certain core curriculum, such as math, English, science, and social studies.

The question came up earlier, should we reject those who have a C average? Is it not important that they obtain a college education? Do we inflate grades? Are we giving an incentive to schools and professors to give Bs to their students? Of course, Bs from one school to another school are vastly different, so I am bothered by that requirement. Of course, it creates additional administrative headaches. Do we really want the IRS beginning to investigate the grades of our students?

Secretary SUMMERS. Personally, Mr. Chairman, I would be just as happy not to have anybody burrowing through my college transcripts. Obviously this is a very important and difficult issue. The way our program is structured, everyone would be eligible for the first year of college, regardless of what happened in high school, because that is all sort of too difficult to evaluate.

The second year would depend upon achieving a B—or greater average, as certified by the college, so the IRS would not be part of that. The IRS would simply rely upon a certification that the student was in good standing with greater than a B average. Similar mechanisms exist today regarding students being in good standing under the Pell grant.

Secretaries Rubin and Riley, I think, have sent a letter that promises careful and sensitive implementation here. I think the basic objective has to be to put the burden on the universities and colleges that are seeking to receive this kind of support for their students to make the certification as to what performance is. This is full cost. This is something that goes beyond what is provided in the context of a Pell grant and is not based strictly on financial need.

So it seems to us appropriate that if this privilege is to be given to a student, that something be expected, that is, that the student be maintaining a good average. Pell grants would continue to be available for all students who are in good standing.

The tuition deduction will be available for all students who are in good standing, but I think the experience in Georgia suggests that that grade requirement can be a motivator. We look forward to working with the committee on this issue.

The CHAIRMAN. I have to tell you, I am very troubled by it because I think it has some very negative fallout that is not in the national interest.

Senator Moynihan, you did not have a chance to make your opening statement, so take whatever time is necessary.

Senator MOYNIHAN. Thank you, Mr. Chairman. Before I do make these remarks, may I say that I am very much conscious that in

Deputy Secretary Summers we have quite the most distinguished academic in the administration at this point. He is an illustrious economist and comes out of a good kennel, as I think the Brits say. In that spirit, I would like to address and take right off on the subject that the Chairman raised.

Secretary SUMMERS. I had a feeling that was going to end.

Senator MOYNIHAN. That is, the judgment and the pronouncement of the Executive Branch in recent years in different administrations on educational matters. Just an anecdote. In 1989, I was in Budapest, wanting to see the last of the old regime there, if you would, and called on the Secretary General of the Communist Party the day I was leaving.

He asked me, how do you get markets going? And I said to him, I will trade you the New York Stock Exchange any day for the Hungarian physics scores. Whatever it is, nothing can stop Hungarians from learning physics, war, devastation, famine, whatever.

The next year, President Bush was speaking in the State of the Union, talking about goals in education. He said by the year 2000, U.S. students must be the first in the world in math and science achievement, and we all applauded.

Then in 1994, we put those provisions into the Goals 2000 Educate America Act, which President Clinton signed. Now, that is fantasy. We could easily have set the goal that we will not drop out of the second division.

The economists just ran a report on these things. On 13-year-olds' average scores in math and science, the United States is right at the median. It ranks 28th in math, and in science it does better, it ranks 17. But Hungary is ahead of us, and everyplace. Hong Kong, South Korea, Czech Republic, Bulgaria. Far ahead of us in science.

Now, 25 years of research has shown that you just cannot find a relationship between the variations in school expenditures and student performance. It is just not there.

So what are we to know about B averages and things like that? Does anybody seriously think we will be first in the world in science and math in the year 2000 in the administration? I mean, if they believe that we have a problem. It would not trouble me at all if they did not believe it.

Secretary SUMMERS. I hesitate to speak to the state of belief of all the members of our administration. I would say that I think there is a very shared conviction in the administration, and it was something that was reiterated very strongly in the President's State of the Union address, and he gave a number of examples, that where we are in math and science education right now is manifestly inadequate and that if it is to get where it needs to go, there needs to be a very substantial effort that goes beyond what we are doing now.

Senator MOYNIHAN. What kind of effort?

Secretary SUMMERS. The President, I think, cited—and I do not remember, I think it was in Detroit—an example of where a community had made a commitment to increase resources to improving the quality of the science education, to setting standards for pupils, and it succeeded in raising test scores to a level that would be above the average of any other country.

Senator MOYNIHAN. First in the world?

Secretary SUMMERS. First in the world? It is difficult to predict when any given objective——

Senator MOYNIHAN. Of course it is not difficult to predict. It is an absolutely fixed fact.

Secretary SUMMERS. There are many parts, Senator, as you know much, much better than I. There are many, many parts of what goes into educational achievement. A lot of it goes into family structure, a lot of it goes into what is expected from students. I was once a very close reader of a volume produced at Harvard University in the late 1960's in the wake of the Coleman report under extraordinarily distinguished editorship.

Senator MOYNIHAN. He is referring to Frederick C. Mosteller, the professor of Mathematical Statistics.

Secretary SUMMERS. There were two professors at Harvard whose name began with M who were involved in that volume.

I think it is fair to say that there has been some research subsequent to that which I think has shown that, while overall expenditures may have a questionable relationship to achievement, that where there are outstanding teachers there are outstanding outcomes, and that particular changes in curriculum do produce measurable and demonstrable changes in achievement. That is what we have to build on. But, fundamentally, if there is one thing that is important, schools and parents have to expect more of our kids, because our kids can do much better.

If the expectations are higher, the bar is set higher, I believe we can do much better. That is what the President's discussions of setting national goals are all about, and I think that is what we have to do. But this is not a process that—the differences between Hungarians and Americans in physics, frankly, did not get made in a year, or 5 years, or 10 years. I think these problems are going to take a long time to address.

Senator MOYNIHAN. I just would hope for a little more realism.

Could I make one last comment, sir, which is that why do you not try to use some of the money over in the Department of Education to get us a feel for the tuition phenomenon in terms of, you mentioned Baumol's cost disease of the personal services. You have a classic example in law school classes of that phenomenon. One professor can teach 50 students today, as he could a century ago. But those students have computers that the Air Force would not have dreamed of having 50 years ago, and it is a relative cost. You could teach us something on this. Why don't you?

Secretary SUMMERS. That is a very useful idea for us to explore in two crucial contexts. It is very relevant to higher education, as you suggest. It also has a lot to do, I think, with phenomena that go on in the health care sector.

Senator MOYNIHAN. Exactly. Thank you.

Thank you, Mr. Chairman.

Senator MOYNIHAN. Senator D'Amato.

Senator D'AMATO. Thank you, Mr. Chairman. I think you touched on a number of very, very important points. Number one, I honestly think that we have got to be very careful when we get into this business about what you are going to require of the student to continue some kind of tuition assistance or tax credit. The

Cs will become Bs. You will find professors in schools that will be inclined to be supportive of giving a student an opportunity to continue and not wanting to place an additional strain or be responsible for them not being able to continue.

I would say to you, particularly during the first year, probably one of the more troubling years for many students, the 13th year, the first year in college, getting adjusted. It is not uncommon to find some who stumble along the way and would be very fortunate to even get a C average, and thereafter continue.

I speak from experience. It was a wild, tumultuous first year at Syracuse. The first time I was out of sight of mom, dad, and the good brothers at Chaminade High School. That freedom and liberty were enjoyed to its fullest, and those pursuits were not academic in nature. [Laughter.] Is it a shock? [Laughter.]

I have always lived perilously close to the edge. But I just share that with you as a personal experience. I also would share with you something that my good friend and colleague, Senator Biden, testified to before. Having an income considerably above those on which there is some limitation, between $80,000 and $100,000 when we begin to phase out assistance, and still having arrived at a point where my son did finish his 4 years of undergraduate at Georgetown and 3 years at Syracuse Law, and I guess about 6 of those years he spent rooming with one son or the other of Senator Biden's.

It was a shared experience, watching the boys grow and mature and go through all that they did. I guess it was a shared experience in terms of the student loans that they have compiled, never reckoning the day that he would say to me, well, dad, I did complete it and you did promise to take over the loans if I completed law school. And they are quite substantial. To the penny, I can tell you what I inherited: $91,700. That is a lot of money.

It is impossible, and that is why I think we have to do something to help working families, and even families that might be considered well-off by any stretch. Young people cannot do this, and they are racking up these kinds of bills. Those are real. Those are real costs.

I think the Senator mentioned, it is impossible today to work one's self through college and professional school, as many of us did in years gone by when your total tuition, room and board may have amounted to a huge $1,500.

My gosh, someone could go out and earn a good portion of that during the summer and could work various jobs, as many people did, to help assist during the course of the academic year. You cannot do that when you have tuition, room and board of $25,000–30,000 a year and more.

So I think it is good that we are focusing on this and I think it is extremely important that we do focus on it. But I have a shared concern with some of the writings of some of the academics and others. The late economist Howard Bowen, my great staffer says that, "Universities will raise all the money they can and spend all the money they raise."

What can be done to see that colleges do not raise tuitions even higher to compensate for the tax incentives like credits, et cetera? I think the Chairman has expressed that. That is one problem. Are

we better off at the end of the process saying that we will give forgiveness, as you say, in terms of community work, those people who work in communities?

Are we better off at the end saying that we will permit deductions for the repayment of these loans, will that help curb the cost or will we just get pass-throughs, which many of us are concerned with? But I will tell you this, this is a serious, serious problem.

Working, middle class families are really bearing the brunt. Their children are coming out with huge debts. They themselves, moms and dads, are forced to remortgage their homes and their properties, as well as borrow to achieve. It is a combination of parent sacrifice, and children. We are not doing nearly what we should be.

I think this is more than taking a poll and seeing what is the most popular. I can support a $10,000 tuition deduction, but is that going to be the best result? How are we going to maximize this effort? I think we should make a special effort to deal in this important area.

Last, but not least, I am tremendously encouraged by Senator Coverdell's bill and the bill that many others are supporting here, which says that the employer-provided educational assistance program should be permanentized. That should be permanentized because we have got lots of people who are struggling. Where the employers work to make that tuition available, I know this committee stepped in because we had so many in the way of graduate courses.

Senator MOYNIHAN. Could I just say to my friend that the Chairman and I have introduced that bill and we very much hope we will get the committee's support on it.

Senator D'AMATO. I think that bill, Mr. Chairman and Senator Moynihan, is important. Just as we have seen in the New York metropolitan area the impact of withdrawing it becomes catastrophic, to the health care industry, to the professionals, to giving those who want an opportunity and who are struggling to go to school at night that opportunity. That is just absolutely terribly important.

So this is an incredibly important area. I commend the Chairman for holding this hearing. I hope that the administration and the committees can work together in a bipartisan effort to fashion a bill that will do the best, because this is deteriorating.

It is very, very painful for families that have some financial stability, to get into this situation. If they are trying to put two or three children through school at or about the same time, it is just incredibly difficult.

Thank you, Mr. Chairman.

The CHAIRMAN. Senator Mack.

Secretary SUMMERS. If I could just make a very brief response, Mr. Chairman.

The CHAIRMAN. Yes. Sure.

Secretary SUMMERS. Senator D'Amato, I think you raise a number of concerns that are absolutely critical, making sure that all kids, not just the kids who are most academically able, get helped on their way through college, making sure that we recognize that these burdens for somebody who has got a few kids who go to a lot of school can be enormous, even for families that would often

be thought of as very well-to-do, making sure that we find a way forward in this area that causes the money to stick to the families and the kids, not to a sector where costs have grown very, very rapidly, making sure above all that we do something about this problem that is getting worse and is getting more burdensome for more families every year.

I think those are things on which we all ought to be able to agree on a bipartisan basis, and we all ought to be able to work together to find whatever the best solution is that marries these objectives, because while there are a lot of priorities, I do not think there are many that are more important than this one.

I think I can speak for everyone in the administration in saying that we look forward to working with this committee and working with the Congress to find the best way forward to support much more availability for higher education than we have had in the past.

Senator D'AMATO. Well, I appreciate that. I honestly do believe that that is a very real concern. I think if all of us keep kind of loose and try to work together for these common solutions which are not so easy—it is easier to identify the problem than come up with the solution—we will make some real progress. I look forward to that.

The CHAIRMAN. I have to say that I think it is a national disgrace. I think there is something wrong when our young people do what is right, go to college, the parents save and work to send them to college, and they end up with these tremendous indebtednesses. I think it is a matter of real concern.

Senator MOYNIHAN. Mr. Chairman, would you mind if I interject to say, let us keep in mind, that debt has produced a remarkably conservative generation of graduate students. [Laughter.]

The CHAIRMAN. That is the reason we want more to go. [Laughter.] Senator Mack.

Senator MACK. Thank you, Mr. Chairman.

If I might just pick up on that comment with respect to the debt that the students have built up over the years. Some of the folks on my staff, when they told me I was really stunned, have over $90,000 worth of loans. I just think about what it would have been like for me, starting out my career in the banking business ages ago with $90,000, or some equivalent amount of debt. I mean, that would have put off buying a home, raising a family. I guess some of those decisions are being made by this younger generation.

But let me get back to something Senator Biden said earlier which triggered a thought in my mind. That is, he said something to the effect that, as bad as our education system is, there is no better higher education system.

I raise that from the standpoint that, at any given moment in time, you have to make decisions about how you are going to allocate your resources. I am just wondering, while it certainly is a popular thing to talk about education and providing all kinds of assistance to people for higher education, if we are not missing the point.

The point is, what is happening in the first 12 years? Again, here we are talking about allocating a pretty good-sized number with re-

spect to the dollars that would be available to assist at the higher education level.

The first question I think that we as a committee ought to grapple with, is just how much we can at this point put into higher education when we know that the major problems that are facing our Nation are in the first 12 years.

The second thing that concerns me, is the emphasis over the years that has built up with respect to the concept of student loans themselves. I think that Senator McConnell and Senator Graham provided us with very useful information today with respect to the advantages that come from a prepaid program, where moms and dads today can begin to set aside $40, $50 a month for their children's education in the future. It addresses one aspect of an economic problem in the country, and that is the lack of savings.

It is interesting to me as well that we continue to place the emphasis on borrowing for higher education at a time when both parties and members of both parties have talked about the importance of kind of changing our Tax Code from the standpoint of encouraging savings, that we would be continuing to push as part of our education program the emphasis on student loans.

So I raise those points because I think it is something we do need to consider as we work our way through an education component to whatever kind of tax proposal we develop this year, because I think we will do something in education. We do need to do something in education, but we have got to consider those two points.

Third, we have got to consider the issue of inflation. I must say, Mr. Secretary, first of all, I appreciate your being here and appreciate your comments, but I do have some concerns about the inflationary issue.

No one should use the concern about inflation to say we, therefore, we should not help those who are trying to get a higher education. What it does say to us, is we ought to find a plan, we ought to pursue a way that will have the least possible effect on inflation.

In fact, if we can find a plan that holds down, that has part of its effort would be, in fact, to hold down the increases in tuition, then that is the plan we ought to pursue. Maybe there is a question that comes to mind. Again, this is not intended to create any kind of partisan perspective, the campaigns are over now.

But I really do believe that Senator Dole's suggestion during the campaign about the $500 per child tax credit, coupled with an education investment account, begins to create the tools for moms and dads to say, all right, if we are going to get some form of tax credit and at the same time we are going to have some kind of an account that we can invest those dollars in that is tax-free, that sounds to me like one of the things we really ought to consider. So I would be interested in, now that the campaign is over with, what your reaction to that concept is.

Secretary SUMMERS. In essence, Senator Mack, the IRA proposal that the administration has made makes exactly that possible. It makes it possible to make tax-free contributions to an account and then to make tax-free withdrawals from that account to send your child to college.

I think you are absolutely right in emphasizing the importance of saving as an important part of this problem, because it cannot

be met all by borrowing. I have done a little calculation. I have three kids, two of whom are 6, one of whom is 3. I have worked out what happens if they all go to a high-tuition school, then they all go to graduate school.

If inflation escalates at the current rate, you are looking at a cost of somewhere between $1.3-1.4 million. I think that makes the point, if you add that all up and you allow the inflation between now and then. I think that makes, very strongly, the point that is being made here, that we have got to find ways to help people prepare for those costs.

And, as you say, we cannot let the fear of inflation be a reason for not providing assistance, but we do all have to think through together, and do it in a bipartisan way, what the best way to provide the assistance is that minimizes the risks that it will feed through to inflation.

The CHAIRMAN. The only comment I would make is that I think, under the administration's proposal as far as the IRA is concerned, on a front-ended IRA it is only tax-deductible, it is not tax-free, I think is correct. Yes?

Secretary SUMMERS. The contribution is tax-deductible, and then the withdrawal is tax-free. Yes.

The CHAIRMAN. Yes. It is penalty-free, that is right.

Secretary SUMMERS. But, because of the $10,000 deduction that the administration's proposal has, while it is taxable, as you say, if you are using it to pay for college tuition you can then deduct the cost of the tuition. So, in effect, the result is that no tax is paid when you make that withdrawal for the purpose of supporting college education.

The CHAIRMAN. Well, in any event the IRA does provide a very viable mechanism of help. I think it is a valuable suggestion.

Senator Bryan is next.

Senator BRYAN. I thank you very much, Mr. Chairman. Let me just preface with a comment. My interest was piqued when Senator Moynihan indicated that our distinguished witness this morning comes out of a good kennel. I am going to restrain my inclination to further pursue that, but at some point in time, perhaps, we can discuss his pedigree in more detail.

I want to make a couple of observations before a question. I would commend you, Mr. Secretary, and the administration for placing a national priority in terms of education. I think that is an appropriate public policy position for us to be in.

The obvious benefits to the individual in terms of what it does to elevate a standard of living, what it can do for our country in terms of our vitality in the economic field, I think, is undeniable. I am one who has been supportive of student assistance programs, both at the State level where I had some service, and at the National level.

I am one who happens to think that perhaps the seminal Federal program, the GI bill, changed the lives of a generation of Americans in a way that was beyond anybody's comprehension and that the economic expansion that we enjoyed in America in the 1950's is a substantial byproduct of that decision.

Having said that, I have got a couple of questions about the proposal. I think the statistics that you provide in terms of those poor

families and the likelihood that their sons and daughters go on to benefit from higher education is undeniable. But, having said that, it seems to me that we have to take a look in terms of how we are spending and allocating our resources.

The first question I have is, what is the total dollar cost in the first year of the programs that you outline here in your testimony that you have released for us, the HOPE scholarship tuition, extension of Section 127 Small Business Credit, expanded tax-free loan?

Secretary SUMMERS. The HOPE and the tuition deduction are about $36 billion plus, and the other provisions, Section 127, is about $3.5 billion. So the total is close to $40 billion.

Senator BRYAN. About $40 billion. All right. Let me say that I do not have a quarrel with spending $40 billion. I think that it is a national priority and that that is an appropriate area for us to invest for the future.

Here is my question. If the concern is to try to bring those economically disadvantaged youngsters who come from poverty backgrounds, to give them the same opportunity that middle income and upper income families enjoy, I am having difficulty to see where a non-refundable tax credit in this HOPE scholarship or the deduction that you outline, how does that reach that targeted area? As a middle income citizen, I can see where I could benefit from that.

My children have completed their undergraduate and graduate and professional educations. But how does that address that group? If we are spending $40 billion and that is the target, I am sure, Mr. Secretary, you agree that we ought to be hitting the target. I must say that I am having difficulty understanding it; perhaps you could show me the light.

Secretary SUMMERS. There are two important aspects in responding to that, Senator. First, the administration's proposals also contain, as an integral component, an expansion of the Pell program, an increase in the Pell maximums, and other adjustments, and those are focused very directly on the neediest students.

Senator BRYAN. And I would agree, if I could get you to hold that thought for a moment. Are we expanding not only the level of the grant but the number of individuals who would be recipients in the administration's proposal?

Secretary SUMMERS. Yes.

Senator BRYAN. All right.

Secretary SUMMERS. Yes. That is really motivated exactly by that concern and the belief that, for some of the neediest, the Pell is the most efficient way to deliver the assistance.

I used to notice this when I was involved in teaching, that in a number of the country's leading universities and a number of major State schools, if you look at the family incomes of the students, it is almost bi-modal.

You have many, many students who come from very, very affluent backgrounds. You have many students who come from quite very limited circumstances and who are eligible for Pell grants and for other scholarships.

You see relatively few students from middle class backgrounds, precisely because there is a middle class there that is caught in be-

tween, not eligible for traditional need-based scholarships, but also not able to afford it on their own.

It is really that population that is centrally targeted by these programs and the increased access for the poor, which is very, very important, is met through an expansion of the Pell program.

Senator BRYAN. Would the Chairman indulge me for just another 30 seconds, if the Senator from North Dakota would allow.

The CHAIRMAN. Yes.

Senator BRYAN. All right. So the $40 billion is targeted then for middle income Americans. All right. I think I can understand that. I understand the logic. But if the thrust or the emphasis is how we bring more youngsters from these economically disadvantaged programs, how much are we spending by way of increases in the Pell grant in any other program that the administration is offering within this educational menu to provide help to them?

Secretary SUMMERS. The Pell grant program would, in the reauthorization and expansion that we are calling for, spend at least $40 billion over the next 5 years and would spend $1.7 billion more in 1998 than in 1997, which represents a 25 percent increase.

Separate from that, an expansion in Pell grants for older, low-income students would cost approximately $3.9 billion over 5 years. The cut in student loan fees that is envisioned in the proposal would save students approximately $2.6 billion.

Senator BRYAN. Is that over the 5-year period?

Secretary SUMMERS. Five years, yes.

Senator BRYAN. All right. My time is up. So we are, in effect, saying that we want to put $40 billion into programs to help middle income students, and these are the programs that you have outlined. Then we are putting $1.7 billion into an increase in the Pell grant. That would be on an annual basis, as I understand. Then whatever, that $3.9 billion, in terms of student fee lowering, works on an annual basis.

I thank you very much, Mr. Secretary, and I thank the Chairman and my colleague from North Dakota for his indulgence.

The CHAIRMAN. Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman. Good to have you here, Mr. Summers. I was just trying a reality test when you were talking about your projections about your children. I was thinking, I have a daughter at Harvard this year, about $32,000. I went to Stanford. I was a freshman 30 years ago and it cost about one-tenth that amount. So it really is striking, the kind of inflation that we are experiencing in higher education.

When I am moving around my State, listening to concerns of parents and talking to the young people who are going to college, how they are going to pay is very high on the list of their concerns.

I can remember very well when we had a caucus, and Senator Moynihan came in with a chart that showed North Dakota had just finished number one in educational performance for 14-year-olds on a series of competitive tests, math and science. I think Montana was number two, and Minnesota and Wisconsin were in the top five.

Then also on the chart he showed what we were spending and we were at the time, I think, 48th out of 50, in terms of what we were spending on education in North Dakota. Senator Moynihan

made the observation, maybe what we ought to do is move all the students to the northern border of Canada, maybe that is the trick.

Senator MOYNIHAN. Sir, may I just interject to say, I provided statistical proof that educational achievement is directly related to the distance of the State capital from the Canadian border. [Laughter.]

Senator CONRAD. Well, see, he said it better than I did.

Senator MOYNIHAN. If we moved more States toward the Canadian border, we would have an automatic increase in educational achievement.

Senator CONRAD. Senator Mack may have a question about that theory, and Senator Graham as well. But it does seem to work out very well.

One of the things that we looked at when we started to try to ascertain why this is happening is very interesting. North Dakota is also number one in intact families, and there is probably a correlation between educational attainment and what is happening at the family level.

One of the concerns I have with the proposal is we know that overall we do not do as well competitively through high school, looking at the rest of the world. Where we catch up is in college and higher education. We are the place that everybody wants to come for higher education. In my State we have hundreds and hundreds of students from foreign countries coming to get an excellent education.

The concern I have is that only about 50 percent of our young people go on to higher education. So what are we doing about the 50 percent who do not have that advantage; what are we going to do to concentrate on that part of the problem?

Something that you said earlier struck me, and that is, we have got to expect more. I was part of the Sputnik generation. I remember when the Russians beat us to the punch in getting into space, in very short order in Bismarck, North Dakota, we had special classes in math and science and we were doing a lot of homework.

When I go home and I ask the young people in high schools, how many of you are doing two hours of homework a night, almost no hands go up. I ask them, well, why are you not doing it? The answer is, well, teachers do not assign homework. And you ask the teachers, why are you not assigning it? They say, well, if we do the parents complain.

You ask, what is the nature of their complaint? The parents say, well, the kids have jobs and therefore are not able to do homework after school. And you ask the parents, why do your kids have to have a job? Well, they have to pay for the car. I mean, it is an interesting set of priorities.

When I was growing up, very few people had a car in Bismarck, North Dakota. And I do not know what we can do in terms of Federal policy that alters the message that is being sent out there about what is important, but the message that we are sending I do not think meets the challenges that we are facing. I would be interested in your observations with respect to that question.

What are we going to do that is going to affect those 50 percent who are not going on to college?

Secretary SUMMERS. Senator, I am an economist, but I recognize that many of our most profound problems are moral. When I was growing up it was thought to be a problem if you spent more time watching TV than you did doing homework.

Today, if you look at the most recent statistics, the vast majority of American 18-year-olds have spent more time watching television than they have doing homework and being in school over the 18 years of their lives.

Without disparaging television at all, that has got to say something about what they are learning and has to have something to do with why the achievement tests are where they are.

I think all of us who have positions that have something to do with leadership have an obligation to make exactly the point that you made about the absolute importance of intact families, which is the key to education, it is the key to fighting drugs, it is the key to reducing welfare dependency, it is the key to so many of our achievements.

I think, though, it is an important part of giving every student something to shoot for and having that kind of American dream there for everyone to make available this kind of support for everyone who can go on to get some kind of subsequent post-high school education.

Because if you think about what college means today, it is actually well over 50 percent of kids who start college, it is closer to two-thirds of kids who have an opportunity to start college in some way.

And only 25 percent of college students are people who live away from home, who live in a dormitory, go to a 4-year college, and major in some kind of liberal arts subject. Many, many of them are going to the local community college to learn how to be a paramedic or to learn how to perform basic services in a hotel, or to do a wide range of other tasks.

So I think it is a mistake when we think of higher education in today's world to think of it as an academic elite kind of thing for which only some people are suitable rather than kind of a basic continuation of training that should be available as a matter of expectation for the vast majority of Americans.

In a way, that is what the HOPE scholarship is all about, it is about creating an expectation that Americans will be able to profit from what they are going to need in the 21st century, which is more than 12th grade, and they are going to need a kind of 13th and 14th grade, often a very vocationally-tailored 13th and 14th grade.

I am not the person to speak knowledgeably to them, but the administration has also proposed a range of youth-to-work kinds of initiatives that are intended to address the problems of what is a particularly high-risk group, those who leave high school early or those who, for some reason, absolutely do not seek training beyond high school. But I think we need to keep some post-high school education as part of the vision and as part of what you are shooting for for all Americans.

Senator CONRAD. Thank you.

The CHAIRMAN. Senator Kerrey.

Senator KERREY. Thank you, Mr. Chairman. Mr. Summers, nice to have you before the committee. I appreciate very much the President's emphasis on education, K–12. The national standards emphasis, I think, is critical if our 120 million workers are going to remain above-average against 3 billion workers worldwide, which I think is the challenge.

We have got 40 million people in the work force right now that earn $7.50 an hour or less, and our challenge is to make sure that those young people, when they come out of high school, have world-class skills.

Right now, there are 4 million high school graduates a year, and 2 million go right into the work force. You do not have to talk to very many employers before you discover them saying that high school diploma is not worth much any more, perhaps associated with the things you were talking about earlier.

So, I really appreciate the President's emphasis on education. He has laid down a challenge to all of us to try to answer the question, what do we do?

What I see as I look at this situation, is an accumulation of debt on students that does not cause me to be terribly enthusiastic about providing a tax exemption that basically could do two things that could also be very bad.

It could add inflationary pressure on the cost of education, making the current problem worse, and it could encourage people to accumulate more debt precisely at the time when it seems to me they are going way beyond what is acceptable.

The amount of borrowing in the 1960's, 1970's and 1980's for college education is less than the amount of borrowing that has occurred just in this decade. In another 3 years, we are going to be seeing an incremental increase of $50 billion a year, without any additional changes in our Tax Code. We borrowed $100 billion in the 1960's, 1970's, and 1980's, just to put that in perspective.

Senator Grassley has the Subcommittee on Credit and Bankruptcy, or whatever it is, in the Judiciary. We have got 1.1 million non-recurring consumer bankruptcies, and an awful lot of those are students who are graduating right now with an average of $10,000 worth of debt that is increasing 15 percent a year.

Now, that is a rate of increase that exceeds even our prison population. So, I mean, you cannot sustain that kind of debt. They are getting married, they are postponing having children, they are postponing buying a house, they are postponing starting a business. So it seems to me what is needed is equity. I have done business deals before and at some point debt does not help me, what I need is equity.

That gets me to the question, has the administration been tormented with the realization that if they accepted the Boskin Commission recommendations and made that a part of their recommendations in the budget instead of taking a pass on that, that that gives us the capacity to debate the possibility of providing equity, whether it is in Pell grants or in another sort of form.

I associate myself with the proposal that Senator Graham is making to expand the ability for people to be able to save ahead. It seems to me that is the kind of proposal that we need to be look-

ing at and it allows people to acquire the resources to make the purchase without having to accumulate additional debt.

I think we are going to find ourselves with a debt overhang that is going to get worse, and at some point we are going to say, wait a minute, this is unacceptable for people who are leaving college.

Secretary SUMMERS. Senator, I share your concern. I think all of us in the administration share your concern and that is why the administration's approach to this problem does not involve any support or encouragement for people to take on debt, but instead involves the HOPE scholarship that provides direct assistance, a tuition deduction that provides direct assistance for families while they are providing support for their children, and an IRA education deduction mechanism that encourages saving.

Senator KERREY. We have a means test right now on being able to go to college. Your testimony says 23 percent of high school graduates with incomes under $29,000, whereas, what is it, 53 percent when the income is over $78,000.

Now, tell me, if I have 4 kids and my income is under $29,000 and you allow me to deduct the cost of college, what does that do for me? I still have kids that are not going to go to college unless I can get a scholarship in some capacity.

I am still going to be borrowing money in order for those kids to go even to the Land Grant College today. I have got people in Nebraska taking out second mortgages on their home, for gosh sakes, to go to the Land Grant College, the public institution.

Secretary SUMMERS. Senator, the reason we have proposed an expansion in the Pell grant is to meet the needs of particularly those that are the lowest part of the income distribution. For those in the $30,000–60,000, say, range, the $1,500 credit does represent a significant form of assistance. In the best budgetary world, we would like to be in a position to do more.

Senator KERREY. The best budgetary world would be the President saying, I endorse the Boskin Commission's recommendation, and that is going to free up additional resources to be able to provide equity, would you not think? Would you not think that would be the best budgetary world?

If you leave here today and the Secretary calls you and says, the President last night was watching television and he got this great idea, and he decided that Senator Roth and Senator Moynihan are right and we are going to accept the Boskin Commission recommendations, would that not be good news?

Secretary SUMMERS. Let me just say this. I think the question of our price indices is a very, very important one, and that the best possible measurement needs to be found on a scientific basis, and very real concerns have been raised, the prospect that they are overstated.

Senator KERREY. I think we need to say to people over the age of 65 that, unless we make that adjustment, that there are going to be American children who graduate from high school who are not going to be able to go to college as a consequence. That is what we need to say, that the world has changed.

In 1997 it is a lot different than it was in 1967.These kids are having to compete not against kids that graduate from across town, they are having to compete against kids that graduate across the

world. We have got to say to people over the age of 65, this adjustment is critical if we are going to continue to be able to say that our middle class is growing. Otherwise I do not believe it is going to grow.

Secretary SUMMERS. I do not think there is any question, as a long-run proposition, that we have to look very carefully at the balance in our country between what we do for all groups and that our young people are a group that is very much in need of more support.

Senator KERREY. Well, a long-run proposition is not very helpful to those who find that the door of opportunity is closed as a consequence of simply not being able to afford to go to college.

Again, I appreciate the President taking the leadership on this because I think he has focused our attention on one of the most, if not the most, important problem the country faces.

But I say with great respect for all the variety of things that he has to decide, unless and until the day comes that he says that Senator Roth and Senator Moynihan are correct, we should accept the Boskin Commission's recommendation and we have got to go to Americans over the age of 65 and say, help us, I have got 4 million kids graduating from high school today and we have a lot of them who are not going to be able to go to college, are not going to get the training they need, unless we make this adjustment.

Thank you.

The CHAIRMAN. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman.

If this question was asked before I arrived, I will pass over it and get the information otherwise. In terms of the proposal for tax credit and tax deduction, what is the estimated number of students who will become college attendees as a result of that who, without that assistance, would be unable to attend?

Secretary SUMMERS. I do not have a figure to furnish you, Senator Graham. I think the comparisons that Senator Kerrey was just citing between the fraction of college attendance among those with incomes under $30,000 and those with incomes above $78,000 points up what I think has been obvious from our discussion this morning, that lack of funds and the high cost of education is an important barrier and it is a barrier that these proposals help families to overcome.

Senator GRAHAM. Larry, frankly, I do not consider that answer to be adequate. I asked exactly the same question 2 months ago when we first had this issue before us. I think Secretary Rubin was the person that I asked it of at that time, but it may have been Secretary Shalala, and I got the same answer. This is an important question in at least two regards.

One, are we talking about a program that is going to be primarily to increase the number of students who have an opportunity to attend higher education, or are we talking about a program which primarily will provide tax relief to families who already are sending students to colleges or universities and will not be affected by the availability of this program in terms of their decision?

Second, is fairness to the institutions that are going to be affected. If, in fact, the principal result of this program is to increase the number of students attending colleges and universities beyond

those who are currently expected, that has serious implications, particularly to community colleges which are going to be primarily affected by the credit program in terms of their physical facilities, their faculty hiring, and a whole range of things, to give them the capacity to accept this larger number of students.

So I think it is a responsibility of the people who were the architects of this program to have some concept of how many students are likely to become attendees if this program is adopted as opposed to those who will be attendees without the additional incentives that this makes available.

Secretary SUMMERS. We will try to furnish you with a written response, Senator Graham. I do not think there is any question that this program is going to benefit a very, very large number of families who would have sent their kids to college anyway and I think that is appropriate because this is, after all, a middle class tax relief program.

And if we think about targeting middle class tax relief, targeting it to families at a time when they are under maximum financial strain seems to us to be a desirable way of targeting middle class tax relief and associating the middle class tax relief with something that I think we all want to encourage, seems to me to be very desirable.

So, while I do expect there to be some enrollments, I think it is very important to understand that this is a program that was designed as a middle class tax relief program that will have the additional benefit of encouraging something that I think we in this country all want to encourage, which is people going to college.

Senator GRAHAM. I think the issues, if this is intended to be a targeted middle class tax relief for those families who happen to have children who are of college age as opposed to a whole series of other alternatives for targeting middle class tax relief, such as for those who happen to have children who are in the preschool ages and, therefore, have the additional cost of child care, et cetera, those are policy issues to be debated.

But, in reading over your statement and the materials that have been presented previously, this is being primarily buttressed not as middle class tax relief, but rather as a means of expanding opportunities for higher education.

If that is, in fact, going to be the principal effect of this program, I think the administration should be able to provide some quantification and, in turn, assist those institutions that will have the obligation of receiving these additional students and preparing to do so.

Secretary SUMMERS. We will try to be as responsive as we can.

Senator GRAHAM. Mr. Chairman, I see my time is almost up. I have completed the principal thrust of my questions. I am pleased that Mr. Summers has indicated he can provide a response, and I would appreciate it if it would be possible to do so in the next 2 weeks.

Secretary SUMMERS. Let me see what we can do, Senator Graham.

Senator GRAHAM. Thank you.

Senator MOYNIHAN. Mr. Chairman.

The CHAIRMAN. Yes.

Senator MOYNIHAN. Before we conclude with the Secretary may I just note that Jon Talisman, who is formerly of our committee staff, is here on the first occasion in his capacity as tax legislative counsel to the department.

The CHAIRMAN. We are pleased to welcome him here as well.

Secretary SUMMERS. I must just observe, Senator Moynihan, that he was extraordinarily well-trained by this committee. It is this committee that is responsible, because he is doing a superb job.

Senator MACK. Mr. Chairman.

The CHAIRMAN. Yes.

Senator MACK. I wonder if I might raise just one more question.

The CHAIRMAN. If it is brief. We do have two panels. In fairness, I think we ought to submit any further questions in writing.

Senator MACK. I would be delighted to follow the suggestions of the Chair.

The CHAIRMAN. So we will keep the record open until 5:00 tonight for additional questions.

Thank you very much, Mr. Secretary.

Senator MOYNIHAN. Thank you, sir.

Secretary SUMMERS. Thank you very much.

The CHAIRMAN. We look forward to working with you on this most important matter.

Our next panel consists of two witnesses. Our first witness is Ms. Jennifer Long, who is a graduate student at the State University of New York at Buffalo School of Dental Medicine, and our second is Mr. Tyler Mathisen, who is executive editor of Money Magazine. We are looking forward very much to hearing from both of you, and appreciate your being here.

Ms. Long, we will start with you.

## STATEMENT OF JENNIFER LONG, STUDENT, STATE UNIVERSITY OF NEW YORK AT BUFFALO SCHOOL OF DENTAL MEDICINE, ON BEHALF OF AMERICAN ASSOCIATION OF DENTAL SCHOOLS, BUFFALO, NEW YORK

Ms. LONG. Thank you, Mr. Chairman. Good morning to all the members of the committee, and especially excellent to see you, Senator Moynihan, this morning, or afternoon as the case may be.

My name is Jennifer Long and I am a graduate of the State University of New York at Binghampton. I am currently a 4th-year dental student at the State University of New York at Buffalo.

I am pleased to present testimony on the student loan interest deduction. I respectfully request that Congress consider a student loan interest deduction provision in any tax legislation being considered this year.

Let me begin by telling you a little bit about myself. I am the first member in my family to receive a professional degree. I grew up in a very loving, single parent household, with a deaf mother on disability. Because I am from a family of limited means, I faced the cost of college alone. I worked very hard and I am proud that I diligently saved and worked throughout college to obtain my education.

I shopped around for the best education I could afford, and consequently chose to attend excellent lower cost State-supported in-

stitutions. Despite my efforts to save money and work hard, I am facing a mountain of debt. Upon graduation, I will owe $90,000.

My student loan payment will average $1,100 per month for the next 10 years. I will pay approximately $7,500 of interest in the first year of repayment. After I graduate, I will be returning to my hometown of Binghampton, New York, where I will begin a career as a general dentist with a practice that includes service to the hearing-impaired community. I will have a salary of approximately $2,500 per month, so the monthly check to repay my student loan debt will eat up nearly 40 percent of my take-home pay.

If the student loan interest deduction is passed this Congress, I would expect to save between $1,500 and $2,000 in taxes in the first year of loan repayment. This is real money. This savings could equal over six months' worth of grocery bills and a year of utility bills. It could be saved, reinvested, put towards the principal on my loans. $2,000 is a lot of money.

My circumstances are strikingly similar to students all across the United States who also have worked hard to obtain an education and who face debts that are equivalent to a home mortgage when they graduate. Like many others, I have this student loan debt burden to deal with before even thinking about the next generation.

I am getting married this June, and before I even start thinking about planning my own family I have to ask myself, how can I save for my children's education when I already face a mountain of debt from my own educational endeavors?

My situation is not unique. In fact, strangely enough, I am lucky in comparison to some students. Many students have much higher debt. For example, Steven Lopez is working as a director of a low-income patient clinic, serving a farm community in Wisconsin. He has $168,000 in student loan debt. Nearly one-half of his pay goes to pay for his student loans.

Another student, Marie Sackett, is a prospective school teacher in the State of Washington and she is the first member of her family to obtain a college degree. This was not an easy endeavor for her. Marie's family has relied on Social Security income since her father died 15 years ago.

To finance her education, she worked throughout college and obtained Pell grants. Despite everything, she will graduate this spring, but with nearly $30,000 in debt. She will be hampered by over $300 in monthly payments on her student loans.

Students nationwide are struggling with student debt burden. I am not speaking only for health profession students, but for all types of students and their parents.

There has been an increasing reliance on loans to finance higher education because grants and scholarships have not kept pace with demand. I could only afford to attend dental school with loans, and for many other students and parents, loans are the only way to finance their higher education.

The indebtedness problem is, of course, compounded when lower and middle income parents attempt to send several students to college at the same time. Also, according to a recent study, low-income and minority students are the groups most likely to borrow at the graduate and professional level.

Current law permits interest deductions for educational expenses paid for through home equity loans. This is not an option for most students and many families who either do not own a home or do not have sufficient home equity. Oddly, the Tax Code allows for the deduction—if I could continue.

The CHAIRMAN. Please proceed.

Ms. LONG. Oddly, the Tax Code allows for individuals to deduct for a second house, but not for a first education. Students are willing to make an investment in their future, but I think the Tax Code should encourage this.

A student loan interest deduction would benefit the borrower after the borrowing is done and education completed. It is not a college or university subsidy. It is clearly a benefit to the individual.

We appreciate the leadership of Senators Grassley and Moseley-Braun in this area, and urge Congress to support a student loan interest deduction. Favorable tax treatment for student loans will immediately encourage investment in higher education and in our Nation's most important resource, people.

Thank you for the opportunity to appear today. I am pleased to respond to any questions.

[The prepared statement of Ms. Long appears in the appendix.]

The CHAIRMAN. Well, thank you very much, Ms. Long. We will ask you some questions after we hear from Mr. Mathisen. But let me say you have been very articulate in expressing what I think is an outrageous situation and something that has to be addressed.

But, before we go to the questions, we would like to hear from Mr. Mathisen. Welcome.

## STATEMENT OF C. TYLER MATHISEN, EXECUTIVE EDITOR AND DIRECTOR OF NEW MEDIA, MONEY MAGAZINE, NEW YORK, NY

Mr. MATHISEN. Good morning, Mr. Chairman. Thank you very much. Thank you for the opportunity to be talking about a subject of such great importance to American families, and as the father of a 3-year-old, to my family as well. I brought him in this morning to serve as my visual aid. I do not know whether he is still here. He had to leave.

Senator MOYNIHAN. He left.

Mr. MATHISEN. He said he had to go out and earn some money to pay for college, is what he said. [Laughter.] What we are really talking about here today is, I think, the American dream, we can all agree. Of all the pieces in that dream, none is more precious to Americans than a college education.

And no wonder. Parents know that America's more than 2,100 4-year institutions are a priceless national resource, a place where minds are sharpened and skills acquired, and they know that the country's 1,500 or so 2-year institutions are a jewel as well, a place to polish old skills, to learn income-enhancing new ones, and to prepare oneself for the rigors of a 4-year school or a career.

Parents also understand something far, far more practical, that higher learning equals higher earnings. By some estimates, Americans earn 5-15 percent more annually for every year they stay in school after high school.

Some analysts calculate that the average lifetime income of a college graduate is $600,000 greater, roughly 75 percent more than

that of an individual who merely has a high school diploma. That earnings gap, as has been pointed out earlier today, is only widening.

But today in America, this dream of higher education is clearly colliding with the reality of tighter budgets, Federal, State, and most importantly, family. It will come as no surprise to you, Mr. Chairman, that the college board pegs the cost of a year at the average State college at $9,649 this year. At the average private school, $20,361, and at the elites, $31,000 or more. Now, granted, a minority of families pay the full list price these days. Yet the high costs and the accelerated rises in them pinch families hard. The costs of public and private schools are roughly double what they were a decade ago, and back then they were roughly twice what they had been 10 years before that. Those comparisons apply only to the average schools.

In the mid-1970's, a year at Harvard, as Senator Moynihan would certainly recall, went for a little over $5,300 all-in. This year, the cost is more than 6 times as much. Since the mid-1970's, reports Money writer Marguerite Smith, consumer prices in the median income of American families with college-aged children have roughly tripled, but the average cost of college has risen more than four-fold, by some accounts even more than that.

Today, the average public school's $9,600 tab gobbles up well over 20 percent of median family income, pre-tax income, up from 10 percent two decades ago. Back in the early 1970's, a year at Harvard consumed less than one-third of median family income; today, 68 percent of it.

Now, one of the singular triumphs, it seems to me, of the 20th century in this country has been the democratization of higher learning. Today, nearly 35 percent of 18- to 24-year-olds are enrolled in U.S. undergraduate programs. Thirty years ago, the comparable figure, just 25 percent, a 40 percent increase in less than a generation. For women, the progress is even more striking. Back in 1967, only one out of five females aged 18 to 24 were in college. Today, nearly double that figure, 36 percent, are.

Those numbers are critical because I believe, as Senator Kerrey pointed out, that the democratization of higher learning not only helps maintain our strong global competitiveness today, but will help ensure it tomorrow.

Yet today, the average middle class family can come up with only 30 percent or so of the costs of a year at a typical public college, to say nothing of what they can afford at a private or an elite school. Moreover, this says nothing of what they may be able to afford if college costs continue to rise at 6 or 6.5 percent a year, roughly double the overall inflation rate.

Take a couple with a 3-year-old child, like me, today. If they want their daughter or son to go to the average State school for 4 years beginning 2012, they ought to be putting aside $182 a month in today's dollars, earning 7 percent after-tax to cover the full $104,000 cost of a B.A. out of their own savings.

If that same couple wants their child to attend the average private school, the figure is $401 a month, every single month through graduation day, to foot what will by then be a $228,000 average bill.

If Harvard is in their sights, they need to be saving $618 a month for what by then will likely be a $350,000 cost. Think about it. $182, $401, or $618 a month every month for every child in your household, until the last of them graduates from college. Could you do it? Could your son or daughter do it? Well, obviously not many families can, and they are very worried about it.

In one 1996 poll, about 3 out of 5 Americans with kids said they fear not being able to pay for their child's education.

Money Magazine has not taken a position on the various education tax proposals that you are considering here today, and I will not advance one either. But I will say that, for your constituents, access to higher education is now, and increasingly will become, the defining factor in whether they enjoy a bountiful standard of living or one merely on society's margins. That is why helping Americans pay for higher education today and to save for it for tomorrow is as important a legislative goal as you will face.

It affects individuals in your State. And because a highly educated work force makes for a more globally competitive work force, it affects us all and is, therefore, a vital national interest as well.

Thank you very much.

[The prepared statement of Mr. Mathisen appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Mathisen.

Ms. Long, let me start out by congratulating you for your perseverance and will to complete your education. I have to say that I find dedication such as yours very, very admirable, and we congratulate you.

Ms. LONG. Thank you.

The CHAIRMAN. But I am very concerned with how this debt overlap will affect the future of students such as yourself. In your testimony you said you are very concerned, because how will you save for your children's education? I think, Mr. Mathisen, you said for each child, $182.

Mr. MATHISEN. $181 a month for the average public school.

The CHAIRMAN. For the average, up to $618 per month. So if you add that to your $1,100 per month payment on your debt, and say you get married and your husband could have a similar debt, I suppose.

Ms. LONG. In my instance he does not, but I think in our written testimony we have examples of couples that share that amount of debt.

The CHAIRMAN. How are you going to plan for your future? How are you going to buy a house and take your mortgage interest deduction? It is an extraordinarily serious problem and I think, one of the things it illustrates is presumably you will be making a pretty high salary.

Senator MOYNIHAN. She is working with disabled persons, so probably not very high.

The CHAIRMAN. The point I want to make is, even if you have what looks like to be a fairly good starting salary, if you add all these things up and compound it, it creates a real problem for you.

I mean, the typical young family that gets married, they want to have children, they want to have the American dream of a home of their own, they want to send their children to college.

So the thing that bothers me is that this is a problem that so broadly impacts negatively on all Americans, except the very wealthiest. How do you look at your future under these circumstances?

Ms. LONG. Well, I think dentists as a whole, and maybe all graduate students, are fiscally more conservative and make choices based on that.

The CHAIRMAN. I applaud that.

Ms. LONG. You make decisions. You may have to put off starting your family or you may not have as large a family as you thought you would have. You need to make responsible choices and informed decisions, delay buying a house, things like that. It definitely affects your quality of life, and it will over the next 10 years, easily.

The CHAIRMAN. Now, let me ask you, some people say, well, the college students have cars and computers and things of that sort, and a lot of the money is being used for so-called unnecessary purposes. Do you find that to be a significant factor?

Ms. LONG. I think some people, like anywhere, would take advantage of the opportunity to have unlimited funds at their discretion. In my instance, in college I did have a car, but I had a car to drive to work so that I could pay for college. I mean, you needed a car to get to work. So in my instance I do not think I took advantage. I tried to pay for things as I went along as best I could, but at $2,500 a year, there is not——

Senator MOYNIHAN. Ms. Long, you are not on trial. [Laughter.]

Ms. LONG. Thank you, Senator.

The CHAIRMAN. We admire very much what you have done and accomplished under very, very difficult circumstances.

Mr. Mathisen, let me ask you a question, if I may. In your testimony, you said that helping Americans pay for higher education today and to save for it tomorrow is an important goal. With that, I think we all agree. But with today's budget constraints, Congress, frankly, may be forced to choose, choose between encouraging savings for college and proposals that provide immediate tax relief to families currently with children in college. If you had to choose, to which approach would you give priority?

Mr. MATHISEN. On a personal level, I would say that I tend to favor savings incentives. I think that that allows people to develop the discipline that they need, it gives them the encouragement they need, to put away money. It also puts the dollars in the consumer's hands at a later point, where they can then apply the money where they want it to go.

So, I think that there probably is some collateral ability there to keep college costs, college inflation, from rising quite as rapidly as it has. That's because, if you put the money in the form of personal dollars personally saved out of hard-earned income in their own savings account, that they can then spend it price-consciously themselves.

The CHAIRMAN. Let me ask you one more question, Ms. Long, if I may. As I say, you obviously have been undeterred by the obstacles you face. But how much of a factor do you think that is in deterring others from pursuing higher education?

Ms. LONG. Well, it is hard for me to gauge. For me, by attending lower-cost State schools, that was a large part of my decision. It dictated not whether or not I would go, but where I would go. They were excellent schools and more affordable to the alternative, but not everybody has that choice.

Some students, if you want to be a dentist, or a mathematician, or get your Ph.D., or your law degree, then you do it. You never see the money. The money is out there somewhere. You owe it. Then after you get your job and you start repaying your loans, then I think that is when it really hits you. But it does not hit you on the front end, because everybody else is doing it.

The CHAIRMAN. Those that are going to college. Do you have any friends who did not go on to college or on to graduate school because of the cost?

Ms. LONG. I cannot say that. I think I know some people who did not pursue specialty degrees and things like that in the interest of that accumulation of debt that they already had.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Mr. Chairman, this has been excellent testimony. May I particularly thank the American Association of Dental Schools for having assembled this extraordinarily impressive group. You are speaking for about 5.7 million people. I would thank Mr. Mathisen for his calculations.

A point to be made, Mr. Chairman, is that we probably were mistaken in 1986 when we took away the deduction for personal loans and we extended that to education loans. As I guess Ms. Long said, you can deduct the interest on a mortgage on a second home, but not on your education. I think we can look at that, and I think we should.

The United States has to watch that we do not become a culture of persons calculating the compound rates at which the costs of 3rd-year college will mean over 55 years of professionalism and so forth. Most of the western democracies simply have free higher education.

You are looking at someone who went to city college for a year, joined the Navy, got the GI bill and a Fulbright Fellowship, and I never saw a tuition bill. I do not know what it cost, if anything. I went through 14 years on the GI bill, or something like that.

We do not want our people entering the fine years of getting married in June on the banks of the Susquehanna and thinking about, well, did I pick my husband because he had no debt. [Laughter.]

Ms. LONG. I thought I was not on trial. [Laughter.]

Senator MOYNIHAN. We really ought to watch this. There ought to be a few years in which you just do not care about such matters. Not only are we producing a lot of people who have to do more calculations than they should, they probably are all going to end up Republicans. [Laughter.]

The CHAIRMAN. That is the best news all day.

Senator MOYNIHAN. Well, there you are. You see, we may not solve this profound social problem because it is in the political interests of some persons not to do. Not you, Mr. Chairman.

It is something to be attended to. Money Magazine does wonderful work in this area.

Mr. MATHISEN. Thank you.

Senator MOYNIHAN. I just want to thank you both.

The CHAIRMAN. I just have to comment on your saying you attended college and graduate school for 14 years. I fear my children are trying to equal that.

Senator Moseley-Braun.

Senator MOSELEY-BRAUN. Thank you very much, Mr. Chairman. I am happy to be able to participate in this hearing and I want to commend you again for calling it.

This is such an important issue for our country, not just for individuals. The President in his speech recently, in the State of the Union address, spoke about education as a matter of our National security. Indeed, there was a meeting or gathering of millionaires and billionaires in Switzerland a couple of months ago in which they referred to education as being the critical issue for our time going into this next century. They described the delineation between the haves and the have nots as being the line between the knows and the know nots, not just for individuals, but for nations as well.

So in this information age, in this global economy, I think it is more important than ever that every person have access to higher education commensurate with that individual's ability. It is not only for their personal well-being and income level.

As you know, there are studies that track the amount of higher education with the amount that an individual will earn over a lifetime, but also for our Nation in terms of our ability to hold our own in this international, global economic competition.

I know for certain I would not be here today had it not been for the access to affordable education that was available in my time when I came through school. We were able to mix part-time earnings with scholarships, grants and loans and come out of college and higher education without a whole lot of debt.

I was able to come out without a lot of debt, and such debt as I did have in college loans I was able to pay off in fairly short order. So, it was not a huge burden or deterrent to achieving a higher education in my time.

But those doors are closing, except for the most determined students. And I want to congratulate Ms. Long again for her determination for taking on what has to be a daunting liability. I guess you did not even have to think about it, just would not think about it so you could go ahead and do it.

But it has certainly made it more difficult for all but the most determined to access higher education, and certainly for those who have more talent than means it has been a deterrent to their ability to realize their potential.

In 1986, as Senator Moynihan points out, Congress, in its repeal of personal exemptions generally, removed the deductibility of interest on student loans. Since that time, however, at least in the last 15 years, tuition costs have gone up about 234 percent.

In fact, I call to the committee's attention, I had commissioned a study by the General Accounting Office on tuition increasing faster than household income and public colleges costs. While they do not exactly know why tuition has gone up 234 percent in 15 years,

it is a reality that Ms. Long and all of her generation are facing head-on.

Senator Grassley and I have introduced legislation to restore that deductibility. It will have negligible pressure on tuition costs because it is personal as to the individual, based on how much college loans they rack up. It is available to them after they have finished their education, and it does not have the refundability issues, so it is not biased to the tax and income level of the taxpayer. It is just a straightforward deductibility, restoring what was previously in the law.

I would call it to the Chairman's attention, as well as the other members of this committee, along with this report, which I actually want to introduce to the record for this hearing so that the staff, particularly, can take a look at it, because I think that we have no more critical issue. To the extent that there are several proposals around, I would very much hope that restoring the deductibility of student loan interest would be one of them.

[The study referred to above is *"GAO/HEHS-96-154—Raising College Tuition and Costs"* which will be retained the the Committee files.]

Senator MOSELEY-BRAUN. Let me ask you the question, Ms. Long, in your experience, and I think Senator Roth touched on it, would you say that some people really do hesitate to go as far as they can go in terms of getting higher education because of the loans that they have racked up really at the undergraduate level?

Ms. LONG. I mean, I think that is definitely the case. It is hard to get a good measure of that, but I think you will find, especially when a young married couple, for example, has debt from both of their educations combined, I think that you very quickly see the reality is, you cannot continue. You cannot specialize.

There comes a point where you have to stop paying tuition and start going to work. Those are very talented people, but perhaps they have made decisions based on money rather than their talents and how far they could go. So, I mean, there is definitely an impact there. What that is, it is hard for me to gauge, but it exists.

Senator MOSELEY-BRAUN. Yes. Mr. Mathisen?

Mr. MATHISEN. It seems to me that when the average medical school student is graduating with $60,000 in debt and the average professional or law school student has $40,000, and the average undergraduate $10,000, that inevitably decisions get made based on the availability of money to be able to continue their education.

Then worse, when such individuals come out of their degree programs, they find that the dollars cannot be freed up out of their incomes to save either for their children's education down the road, for their own retirements, or for their basic living needs, whether it is housing, clothing, or whatever.

Obviously, if young people do become parents, the costs of just having and raising a child are intense. So if you have large monthly payments going to your student loans, your ability to save now for your immediate goals for your family and yourself are compromised.

Senator MOSELEY-BRAUN. Thank you very much.

Mr. Chairman, I would just say in closing that we talk about promoting savings and investment as a part of the Tax Code, and it

seems to me that this is absolutely consistent with both of those goals.

The CHAIRMAN. Thank you, Senator Moseley-Braun.

Let me thank both of you, because I think you have fleshed out very well the problem, how this impacts on people. It is not just an abstract theory that has no real effect on the lives and future of this Nation.

So, Mr. Mathisen, we certainly appreciate your being here. I can tell you, Ms. Long, that you have had a real impact. Good luck. I appreciate your taking the time to join us. Thank you very much.

We now will proceed to the fourth and final panel. We are very pleased to have Hon. Marshall G. Bennett, who is the State treasurer of Mississippi; Mr. John Barry, who is an economic policy analyst at The Heritage Foundation; Dr. David Breneman, who is a professor and dean of the Curry School of Education at the University of Virginia; and Dr. Michael McPherson, who is a professor and president of Macalester College; and, finally, Ms. Kathleen Thompson, who is vice president of Human Resources for Tricor.

Thank you all for being with us today. We look forward to hearing your viewpoints. Will Mr. Bennett please begin.

## STATEMENT OF MARSHALL G. BENNETT, TREASURER, STATE OF MISSISSIPPI, ON BEHALF OF THE NATIONAL ASSOCIATION OF STATE TREASURERS AND THE COLLEGE SAVINGS PLAN NETWORK, JACKSON, MS

Mr. BENNETT. Thank you so much, Mr. Chairman, for allowing us to be here today.

I come not only representing the State treasurers of all the States around the country, but the College Savings Plan Network, which we have formed among the States to work toward the interest of the people involved in prepaid plans.

Our State, Mississippi, has just joined the rest of the States that are involved in this in offering a prepaid plan. Mr. Chairman, I would like to commend you on your op-ed opinion that I just recently had a chance to read that was published in the News Journal in Delaware.

But this should be circulated, I think, to as many national publications, because you have succinctly and very eloquently said, and I think captured the thoughts that we have in the value of prepaid plans.

If you had asked the American family 10 years ago what their number one financial concern would be, it would have been, how can I afford my retirement; what am I going to do about that?

Today, if you ask the American family that same question, what is your number one financial concern, the soccer moms across America will very loudly tell you that the question is, how can I afford to send my kids to college?

The value of a college education is unquestionable, but we need some relief. Some financial demands that are put on the American family are increasing with the tax burden. I think it is a wonderful idea to replace debt with savings. To be able to lock in a price today for tomorrow's tuition, and then get a tax benefit on top of that would be a wonderful opportunity for Americans to experience.

We feel like the Federal Government now is catching up with the States' efforts, since 19 States already offer prepaid plans, 4 more are coming on board this year. We have published, Mr. Chairman, a booklet outlining all of the State plans that are currently in effect, prepaid plans, bond plans, unit plans, contracts, that we have made available to the committee. We hope that you will have a chance to look at that.

Your colleague and my friend, Senator Trent Lott from Mississippi, and I were in college together. We were cheerleaders. We were on the work study program together while we were students. We have both sent daughters and sons to college.

I can tell you that we have borrowed student loans, parent loans, bank loans, life insurance policy loans. Our mothers, when we were in college, worked and, as we say in Mississippi, scrimped, scramped, and scrumped to get enough money together to help pay for our college tuition, that we are going into debt to pay for our children's college tuition. I myself will be paying my college senior's tuition over the next 15 years with the loans that he and I have taken out.

In Mississippi, we know that half of the new jobs that are created in the next 10 years will require postsecondary education skills and training. Telecommunications is growing, health care, finance, the service sector.

Federal and State revenue may very well increase with a prepaid college tuition plan being offered, for it is said that the more we learn the more we earn, the more we earn the more we are going to pay in taxes.

We should not put the American taxpayer in the position of watching the IRS and the States battle like we have for the last 10 years under the Michigan plan when it was challenged in court by the IRS on their tax-exempt status. You cured that last year with the legislation that you passed.

But it discourages people from getting involved in this. What the Federal Government can do and this Congress can do, is actually encourage people to utilize these plans and utilize savings. The prepaid trust funds that are in existence are actively managed professionally with safe and productive investments. The money that is put in there already has been taxed to the taxpayer.

What has been the reception? Senator Graham pointed out that today over 600,000 people are enrolled, by the end of the year there will be more than 1 million Americans enrolled in prepaid plans in those States offering it.

As soon as you correct the tax inequity by allowing the tax earnings to be exempt from taxation, you will see every State adopt such a plan and there are more coming on each year. Tennessee comes on in May, Colorado comes on in the following months this year.

In our own State, our office in the last 5 to 6 weeks, as we offered this starting February the 1st, Mr. Chairman, we have gotten 32,000 telephone calls requesting enrollment forms in my office. Have you gotten 32,000 calls recently in your office?

You know what that results. Every person in the treasurer's office that we could put on the telephone, we did, answering our citizens' requests for information on this.

In fact, our first contract that came back was a lady that sent in a check for $15,000. I called her. She is from Bay St. Louis, Mississippi, and I said, Mrs. Keifer, the maximum costs will be only $10,500. She said, I want to enroll. Just keep the money, figure it out later, and then send me a refund of everything that I do not owe you, she was that enthusiastic about it.

Mr. Chairman, we want to encourage you, and I want to thank Senator Cochrane of Mississippi for coming on the McConnell-Graham legislation that might be introduced this afternoon as a sponsor. The question today will not be from the child to mom and dad, can I afford to go to college, but the question will be, mom and dad, which college do you think I ought to go to.

We support your efforts to improve the participation in prepaid plans and we support the McConnell-Graham and Coverdell legislation, and thank the committee for considering it.

[The prepared statement of Mr. Bennett appears in the appendix.]

The CHAIRMAN. We will have you testify in the order I introduced you. Next, will be Mr. Barry, Dr. Breneman, Dr. McPherson, and end up with Ms. Thompson.

Mr. Barry.

## STATEMENT OF JOHN S. BARRY, ECONOMIC POLICY ANALYST, THE HERITAGE FOUNDATION, WASHINGTON, DC

Mr. BARRY. Thank you very much, Mr. Chairman and members of the committee for inviting me here today to testify about family savings and paying for college.

It is no secret, of course, now that a college degree is a prerequisite for economic success in America today. It is also no secret that paying for college has become increasingly difficult for American families. I think this is for two primary reasons.

First, to put it simply, a college education is extremely expensive. But also, and let us not forget this, parents can never be sure of exactly what tuition costs will be in the future, which makes financial planning a headache, to say the least.

Any plan meant to help parents and students preparing for college must, therefore, one, help control the costs of that college, and also, two, remove some of the anxiety that arises from constantly changing tuition increases.

Unfortunately, President Clinton's HOPE scholarship does neither. In fact, the administration's plans would make matters worse, most likely increasing the cost of college, as you have heard before, and also doing nothing about the anxiety that families feel when preparing to pay for school.

The alternative is to get to the root of the problem and not add injury to insult. Mr. Chairman, it is time to stop penalizing Americans who work hard and save for college.

I fully support your efforts to allow families and students to save for higher education tax-free. This approach has the potential to both control the costs of higher education and also alleviate the pressures families feel in the face of uncertain costs.

Title 3 of Senate bill number 1 does just this, by creating tax-free higher education savings accounts. With a few minor clarifications, the approach adopted in Title 3 of S. 1 would give the par-

ents of more than 19 million students who work hard and save for college the break they so desperately deserve.

Specifically, Title 3 of S. 1 would, first, make the build-up of earnings in State-sponsored tuition plans completely tax-free. In addition to the 19 plans that exist and the 4 coming into existence, there are nearly 20 more States that have established some sort of college savings plan, or are studying the feasibility of these plans.

Taken together, the State plans are a wonderful exercise of federalism, because each is designed differently depending on the demographic composition of the State and the institutional structure of each State's education system. Making the earnings from these plans tax-free would further encourage these innovations and benefit an ever-increasing number of families.

Title 3 of S. 1 also permits parents of students to establish a tax-free higher education and savings account similar to a Super IRA. Contributions to the tax-free education account would be made in after-tax dollars and the earnings would be withdrawn tax-free.

Also, and most importantly, each tax-free savings account may contain several different investment vehicles, just as any specific IRA may contain holdings in several different mutual funds. This is important, because it allows parents the flexibility to diversify their savings, but always receive tax-free earnings on the account as a whole.

Third, Title 3 of S. 1 could be easily modified to allow for individual savings assets to be transferable between two students' accounts. This is very important because it grants families the freedom to tailor their savings plan to their changing needs.

For example, you can imagine that private schools may begin to offer bonds denominated in units of education, and a market might even develop, allowing families to trade their bonds with other families so that everybody can meet their unique goals. Such a possibility certainly meets our criteria of helping control both the high cost and uncertainty of tuition.

The possibilities really are endless. Perhaps a young couple with a newborn child could purchase a call option, redeemable on a set date in the future, thus locking in today a certain amount of education for their young child at a minimal cost.

If the young family's plans change, then they could simply trade such a call option on the open market for another asset, all under the tax-free umbrella of a higher education savings account. Perhaps local service clubs would use the tax-free education savings accounts to establish scholarship funds for promising local students.

The key to all of these possibilities, as well as to controlling tuition hyperinflation and uncertainty, is to make all savings for higher education tax-free. Title 3 of S. 1, with a few minor clarifications, would do just that; the President's plan would not.

Thank you again, Mr. Chairman. I look forward to any questions that you might have.

The CHAIRMAN. Thank you, Mr. Barry.

[The prepared statement of Mr. Barry appears in the appendix.]

The CHAIRMAN. Dr. Breneman.

**STATEMENT OF DAVID W. BRENEMAN, PH.D., PROFESSOR AND DEAN OF THE CURRY SCHOOL OF EDUCATION, UNIVERSITY OF VIRGINIA, CHARLOTTESVILLE, VA**

Dr. BRENEMAN. Thank you, Mr. Chairman. Unlike Ms. Long on the previous panel who spoke for 5.7 million, I will take credit for speaking only for myself.

I believe I was invited to this panel primarily to comment on the Clinton Administration's tax proposals rather than on the savings accounts. I am going to trigger my remarks to some of the questions that were asked in earlier panels.

My assumption, as an economist who has followed this area for some years, is that the one of the principal criticisms of these proposals is that I think they will, in fact, change very little in anyone's behavior. They will not be enrollment inducers.

In fact, I was thinking in response to Senator Graham's question about how many new students might these credits bring into higher education, I do not know what is in the assumption of the administration, but they presumably had to have a number in mind if they came up with a dollar estimate of the cost.

My guess is they just applied the cost to existing enrollment rather than assuming any growth, but at least there should be a number of students underlying the cost estimate that they have given you.

There is one group, though, I think, whose behavior will be influenced. Although this is a murky area and I do not try to speak with any great precision here, I think the institutions will, in fact, find ways to capture much of this for their own benefit. It may well be that a program of institutional aid is a good thing for the country right now, but we are not debating that.

I want to be on record of supporting the general sense of this entire panel, that education is very important and worthy of investment. But I do not think we are promoting the benefits as benefits to institutions, we are promoting them as benefits to middle income families.

As Dr. Summers did, I would like to break the institutions into a couple of different classes. Many of these students who would be eligible for these benefits would also be applying for student financial aid at those institutions that award it from their own funds and other sources, and as a former president of a private college I know something about how that process works.

Every good financial aid officer in a private or public institution that does much aid is trained to find and identify every source of additional resource other than the institution's before that is put in as a final filler. It defies logic, in my mind, to think that the existence of, say, a $1,500 credit made available to a family would suddenly be ignored by the financial aid community.

I should note, too, that that type of exchange is one that need not raise the posted tuition of the institution, but it simply reduces the amount of financial aid that the institution may give to the student. So there will an increase in the net price to the family, but you would not necessarily see this as $1,500 in the sticker price. That is one version.

Another set of institutions are 2-year colleges, many of our public institutions, and certainly the proprietary sector, if they are in-

volved in this, that do not do much of this internal discounting and financial aid.

Those institutions could only capture the benefit of the credit if they raise their tuition. There I think we are into a political price-setting mode. Public tuition prices are not rational in any sense, they are a negotiated price based on the politics within each State, but you have at least set out there a pot of money that a State legislator or Governor could imagine capturing through tuition increases over time that we would never be able to trace back directly to any particular source of funding, but it would be there as a lure.

At the back of my testimony, I think a useful way to think about these plans is whether, if you were to put them out as a direct expenditure program, they would have a compelling sense of equity and efficiency.

If you have my testimony with you—I do not have a nice visual—on the back of my testimony, The Brookings Institution Brown Center put together for us a distribution by family income class of the Pell grant proposals, the loan subsidies that are built into the Stafford loans, the distribution of the benefits of the tax credit, and the tax deduction. These are done for three cases, a public community college, a 4-year public, and a 4-year private.

I submit that, visually looking at the distribution of those benefits, I have a hard time getting very excited about the tax benefits as the kind of financial aid program that one could support.

I think there is a serious problem here, and I am sorry my testimony is somewhat negative on this point. I think the issues that have been raised today challenge our community to come up with answers.

I am not a close student of the various savings plans that are being developed, but it does strike me that for the middle income family the issue is less one of whether a $1,500 reduction in taxes will make a big difference to them, but they have a financing problem and we ought to be working on ways to make financing of this high-priced investment possible.

I submit there that some of the testimony we have heard in earlier panels and in the panel today is probably more directly relevant to the needs of this community than the tax credit and tax deduction.

[The prepared statement of Dr. Breneman appears in the appendix.]

The CHAIRMAN. Thank you, Dr. Breneman.

Dr. McPherson, please.

## STATEMENT OF MICHAEL S. McPHERSON, PH.D., PROFESSOR AND PRESIDENT, MACALESTER COLLEGE, ST. PAUL, MN

Dr. MCPHERSON. Thank you, Mr. Chairman.

Like Dr. Breneman, my remarks will focus on President Clinton's proposals for tax credits and tax deductions. Also like Dr. Breneman, I am speaking only for myself.

My own research in this area, which I have conducted with Morty Schapiro of the University of Southern California, and also our study of the literature, persuade us that there are sound rea-

sons to support the President's commitment to expand Federal funding for higher education.

Economic returns to attending our Nation's colleges and universities are at historic highs, and there are few who would dispute the great value of the non-economic returns as well.

At the same time, Federal dollars to support students' efforts to get a college education are, and will continue to be, very scarce. So it is important to focus support on students who need it most and to provide support in ways that are most likely to achieve the desired effect: encouraging students to attend a suitable college and to do well there.

This is a time of great achievement and great challenge for American higher education. Despite extraordinary real increases in tuition over the past two decades, the percentage of high school graduates attending college is around 60 percent, which is an all-time high. It is not hard to explain why. While in 1980 a student graduating from college could expect to earn about 45 percent more than a high school graduate, today the differential has almost doubled, to 85 percent.

Economic studies place the return to an investment in the college education at more than 10 percent, a figure that compares quite favorably with stocks and bonds. So, even in the narrowest economic terms, higher education is a sound investment. When one adds the important non-economic benefits, the case for allocating more money to postsecondary education is even clearer.

Yet there are significant challenges. Even as overall college attendance rates have grown, the gap between enrollment rates of students from richer and poorer families has widened. For low-income students in many States, the range of institutional types within higher education is becoming increasingly restrictive.

Our studies of the college destinations of students from different income backgrounds indicate that rising prices at public universities and 4-year colleges, coupled with inadequate student aid for the neediest students, are forcing an increasing percentage of students from low-income families to attend their local community college whether or not that is the best alternative for them in light of their aspirations and capacities.

Evidence developed in our work and by other researchers shows that subsidies to lower income students are much more effective in stimulating enrollment and expanding educational choice than are subsidies to students from more affluent families.

There is substantial evidence that rising public tuitions, coupled with inadequate student aid, have produced a crisis of college affordability for many low income and some middle income students, so expanded Federal investments in higher education are a worthy aim.

If this premise is accepted, the central questions before the Congress are two. First, what is the most effective vehicle for expanding Federal higher education investments, and, second, which students should be the target of such an expansion?

Our belief is that direct increases in spending on Federal grant programs for college students are a more straightforward, transparent, and more easily managed vehicle for expanded Federal spending than our new Federal tax breaks.

An important benefit of grants for people who are struggling to meet college costs is that the funds are available immediately; tax benefits arrive many months after the fact.

Yet we also recognize that, in the current political climate, tax breaks are more politically saleable than are spending increases with equivalent impacts. In this light, we believe that the attractions of a tax cut program for higher education depend critically on the targeting of the benefits.

Unfortunately, the most recent incarnation of the President's tax proposals has, we think, some serious drawbacks. As we have discussed, low-income families have suffered the greatest reduction in educational opportunity.

Yet the Clinton tax credit proposal denies tax benefits to those who receive $1,500 or more in Pell grants, who are generally low-income students, while neither the tax deduction nor the credit provide benefits to the lowest income families who do not have enough taxable income to qualify for tax relief.

Moreover, the tax deduction the President has proposed will provide greater benefits to persons in higher tax brackets, a result that is hard to justify either in terms of distributive equity or in terms of efficiency in generating higher college enrollments.

President Clinton's proposals could thus be substantially improved, we think, by focusing on credits rather than deductions, by allowing students to benefit from both tax credits and Pell grants, by making the credit refundable, by eliminating the B– grade requirement, and by limiting credits for families with higher incomes.

Such improved targeting of benefits would make the consequences of this program similar to an expanded Pell grant program, an alternative that is, in our view, more desirable as policy but may well not be politically feasible.

We are encouraged by the President's proposal to increase the maximum Pell grant from $2,700 to $3,000, but over the past 15 years college tuition has risen by more than 75 percent above inflation, while the maximum Pell grant has fallen by about a quarter. So, to restore the real value that the Pell grant had in 1980, we would need a grant of around $4,000.

If an increase of this magnitude is out of the question, then an alternative way to get money to those low-income students who desperately need it should be considered. Thank you.

[The prepared statement of Dr. McPherson appears in the appendix.]

The CHAIRMAN. Thank you.

Ms. Thompson.

## STATEMENT OF KATHLEEN THOMPSON, VICE PRESIDENT OF HUMAN RESOURCES, TRACOR, INC., ON BEHALF OF THE AMERICAN ELECTRONICS ASSOCIATION, ROCKVILLE, MD

Ms. THOMPSON. Good afternoon. My name is Kathleen Thompson. I am corporate vice president of Human Resources for Tracor, Incorporated.

Thank you for the opportunity to discuss reasons why my company, as well as many other employers and all of our employees, would benefit from legislative action to permanently extend Section

127 and to have it include both graduate and undergraduate courses.

Tracor, Incorporated is the fastest-growing defense electronics company in the U.S. today, with 1996 sales exceeding $1 billion. We employ over 10,000 employees in 38 States. In our 1996 annual report, our CEO attributes our growth to the company's "committed and talented employees." It is those people I would like to discuss today.

Tracor has over 400 employees currently participating in our educational assistance program. I include myself as a beneficiary of the program, having been with the company 25 years. In fact, I was putting my son through college through part of that, and we graduated together in the same year. I do not believe that I would be in this job today had I not pursued a degree, and I could not have done it without Tracor's assistance.

With the increased costs of a college education today, the average working person simply cannot afford to complete a degree without some financial assistance and employers have willingly provided that assistance because of the expected return on their investment.

I cannot stress enough the struggle that employees and their families have today juggling work and personal life, but when a person makes a commitment to pursue a degree, that struggle intensifies as the time for the course work is added to the equation. Enormous personal sacrifices must be made to balance it all.

Some of those personal sacrifices involve finances and we know for a fact that some of our employees have curtailed their studies as a result of the on again, off again taxing of their reimbursement. Others simply do not understand why they are taxed one time and not another.

About 28 percent of Tracor's tuition program participants are pursuing graduate degrees. One of these employees sent me an e-mail this week, telling me that his Tracor tuition assistance of $840 yielded a total of only $453.68. He further said, "Continued education and graduate degrees are a priority, not just nice to have." Every tax dollar levied on tuition assistance only increases our student loan debt and increases the burden on those of us striving to live the American dream.

Government RFPs are increasing their requirements for advanced degrees and Tracor simply cannot compete without them. We do not want to see certain employees suffer a tax liability depending on the level of education they pursue, especially if we are strongly encouraging them to do so.

We believe that both undergraduate and graduate educational assistance must receive equal tax treatment. Our employees are pursuing mainly technical, engineering and business degrees at both graduate and undergraduate levels.

The high level of engineering and technical participation is very significant to Tracor's ability to acquire the critical skills needed for current and future business requirements.

Tracor, along with many other employers today, is experiencing the same difficulty in recruiting and retaining people, particularly those with software development skills.

The Sunday edition of the Post carried 15 pages of computer want ads. Tracor is competing in a global economy with unprece-

dented technological advances. To stay current with these changes, we must provide every opportunity and advantage to our work force to increase and upgrade their technical expertise in order for the company to remain competitive and profitable. That profitability then translates to Tracor providing even more jobs for the economy.

We can assume that, with increased skills and education, employees will throughout their careers, whether at Tracor or somewhere else, advance to higher-paying positions than they would have without this increased knowledge. This, in turn, will translate into more tax dollars for the country, certainly far exceeding the dollars lost from taxing tuition assistance.

Finally, I would like to note that Section 127 has been reinstated retroactively a total of 8 times. This has created innumerable administrative burdens for employers and constant confusion for employees.

As an example, with the last retroactivity, Tracor had to prepare corrected W–2 forms and corrected State and Federal tax reports, as well as refund FICA tax. This is bureaucracy we can surely do without in an age where continuous process improvement is a way of life for every profit-making organization today.

In closing, I would like to thank the committee for this opportunity to come before you, and special thanks to Chairman Roth and Senator Moynihan for introducing S. 127. Thank you.

[The prepared statement of Ms. Thompson appears in the appendix.]

The CHAIRMAN. Well, thank you, Ms. Thompson. You have stolen my question. I was just going to ask you whether you supported the Moynihan-Roth proposal to make this favorable tax treatment permanent or not.

Senator MOYNIHAN. I got the impression she would.

Ms. THOMPSON. Absolutely.

The CHAIRMAN. Mr. Bennett, let me ask you a couple of questions. First of all, who is signing up for these States plans, is it just the wealthy or the middle class, or is it across the board?

Mr. BENNETT. It is primarily across the board, in the middle income area. We find that almost 45 percent of the enrollees in many States are grandparents that are able to purchase this for their grandchildren and present them at their first birthday party with a certificate with the State seal on it, and curlicues all around it, and say, honey, this is your college education, it is paid for.

So, that is a good inducement for grandparents. The kid probably will not react very favorably to it at that time, but the parents sure will. They will be thankful. It is across the board, and then middle income people, Senator.

The CHAIRMAN. A second question. Under these plans, as I understand it, for most of them, if a child decides he does not want to go to a State institution the State will return the contributions made to the program, possibly a little of the return or earnings of that money, but that tends to be minor. Is that a windfall?

Now, I understand there is risk for the State institution in this program. At the same time, if one takes that program out in the first year and keeps it going 15, 16 years, the earnings on that should be quite substantial.

So should there be some requirement of more return to those who stay, particularly if the child goes to college out of State?

Mr. BENNETT. Well, I think the idea of these plans is to make them as user-friendly as we can make them. Most of the States that are coming on-line now are allowing the flexibility of portability so that the child, when they decide to go to college, they can go to a State-sponsored university or a community college, or to a proprietary school, or an out-of-State public or private school and the plan will pay that school of their choice what it cost to go to an in-State university. That is true in our plan.

The CHAIRMAN. Is that generally true?

Mr. BENNETT. A majority of the States do. The majority of the students that are enrolling, Senator, 72 percent, choose to go to an in-State community college or university. So the great majority of the students are staying in-State and utilizing it.

Now, on the tax windfall question, certainly if the money is drawn out of the plan, if the plan is canceled or terminated and the person asks for a refund, many States not only offer a refund but do offer a refund plus some interest.

Our own plan allows for a minimum, a floor, of the passbook savings rate at a commercial bank that is currently paid and we calculate that each year. And would offer that back to them, less a diminimus penalty, as the current IRS rules require. So, if they use the proceeds for a purpose other than education, then of course they expect to be taxed on that.

The CHAIRMAN. Dr. Breneman, some of your colleagues have argued that competition between schools will keep costs down. Would you agree with that proposition?

Dr. BRENEMAN. Not really. To some degree, of course. The 18-year-old population peaked in 1979 and we have been through and we are just coming out of this big, long period of the slide in the traditional college-age population. All of us who were writing in the late 1970's thought that the 1980's were going to be a very, in a sense, deflationary time, that we would not see price increases.

The big fear was the tuition gap between public and private. Lo and behold, the 1980's were the period of the enormous price increases in what would have been, or should have been, one of the most competitive environments higher education has ever faced. Strange and other things derailed those early projections.

Senator MOYNIHAN. Could I ask, what did you say, strange and other things?

Dr. BRENEMAN. Yes. I have even written a book to try to understand why that happened. But higher education got into a whole marketing mentality. We got into the notion that price was a signal of quality. People were trading into quality and it became possible to raise prices.

But I think the bottom line on the competitive thing for me is, it does come back to Howard Bowen, who was cited earlier today, that institutions are very adept at and have many sources of revenue and they try to maximize those sources from all angles.

The elite institutions right now, the question you have to ask there, is what keeps their prices down. They are so potentially over-subscribed. I mean, Princeton could be filling up at twice the tuition it is charging.

It becomes a fairly subtle question as you get down into the less prestigious institutions. They are really struggling and some of them may not be able to capture all of this credit. It is not easy to give you a quick and simple answer to that question.

The CHAIRMAN. My time is up.

Senator Moynihan.

Senator MOYNIHAN. First, may I just thank Ms. Thompson for her proposal. We have 36 co-sponsors on our proposal to make the employer-aided educational assistance permanent. The administration, I do not know what to say. Due to budget constraints they want to extend it for 5 years entailing more gaps and retroactives, and so forth.

I think of all the wonderful job opportunities with computers and the year 2000 problem will mean. All of those people you can send back to school to learn obsolete computer codes so you can make sure the missiles do not go off at the wrong time. There are lots of opportunities.

I was struck by Dean Breneman's remarks. It is a bit of a mystery because one of the great facts of education in the last 50 years is that enormous flood of 14- to 24-year-old people into the population in the 1960's.

From 1890 to 1960, the size of that cohort grew by about 10 million people, then in one decade it grew by 14 million, then it went back to its traditional size. Then, in the 1980's, it declined. So when demand declines, prices rise. Well, there you are. I will have to read that book. It is a nice point that the "elite" institutions could probably double their tuition and fill up their classrooms.

But for Dr. McPherson, economists all, Larry Summers spoke about a bi-modal distribution in classes these days, in student bodies, from higher incomes and lower incomes, and the middle is missing. Do you find that? You do not seem to think so.

Dr. MCPHERSON. Well, I have been involved in some research in this area and there is a very familiar story, often stated as fact, that middle income students have been fleeing private colleges as a result of the pressures of tuition and relocating to public colleges and universities.

It turns out that there is zero evidence, when you look at the destinations of students from 1980 to 1994, of that kind of movement of the middle class. The overall rate of participation in college is up, including up among middle income students. So that is a plausible myth, but I think it is, in fact, a myth.

Senator MOYNIHAN. Well, Mr. Chairman, I would just like to say that I have learned a lot, and also I have learned there is a lot we do not know.

If Dr. Breneman could have the goodness, perhaps, to give us a precis of what his findings on these matters are in writing, when you have the chance.

Dr. BRENEMAN. All right. I will do that.

Senator MOYNIHAN. I do think the more we learn about Baumol and the cost disease of personal services, the more we will understand this. It is a change and shift in relative prices.

Dr. MCPHERSON. Senator, could I be allowed just to comment on the State prepaid tuition plans, because I do think that the question that was asked about portability is very important.

It would seem to me reasonable in the Federal interest, in the national interest, to encourage and require, in fact, portability as a condition of getting the tax preference. There is no reason from a national point of view why we should want to either keep students in-State, keep them at a certain class of institutions. The more students have the choice, I think the better.

Senator MOYNIHAN. Thank you. Thank you all very much.

The CHAIRMAN. Let me ask Mr. Barry, would you care to comment on that?

Mr. BARRY. Well, I would say simply I do not think there needs to be a Federal mandate to bring this about. We have already seen with the States' plans an increase in portability.

The scenario that I have described about making all plans available in these tax-free savings accounts would certainly increase portability. And, in fact, a number of private institutions and private associations of colleges have already contacted myself and others about setting up similar plans to the State ones.

So, I do not think we need a Federal mandate of any kind, I think you give people the incentive to save and allow the portability and it will come about through the market.

The CHAIRMAN. Well, ladies and gentlemen, thank you very much for being here today. It has been very educational for all of us.

Senator MOYNIHAN. Yes, it has. Yes, indeed.

The CHAIRMAN. The committee is in recess.

[Whereupon, at 1:07 p.m., the hearing was concluded.]

# APPENDIX

## Additional Material Submitted for the Record

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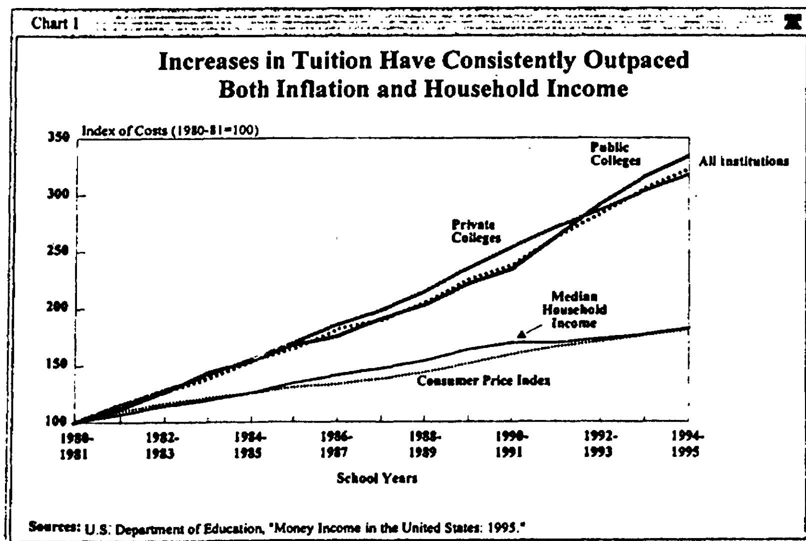
### Prepared Statement of John S. Barry

Mr. Chairman and members of the Senate Finance Committee, my name is John Barry and I am an Economic Policy Analyst at the Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation. Thank you for the opportunity to testify before you today on family savings and paying for college.

Mr. Chairman, it is no secret that a college education is a prerequisite to economic success today. The figures speak for themselves. In 1980, a college graduate earned about 43 percent more per hour than a person with only a high school degree. Today, that earnings advantage is more than 73 percent.

It is also no secret that paying for college has become increasingly difficult for American families. Again since 1980, the cost of public higher education has increased 234 percent while the general rate of inflation and the average household income have increased only about 80 percent.




The problem is not just that college costs a lot, but that the cost is uncertain, making it hard for families to know how much they must put aside or what debt they or their children will

have to incur to pay for a college education. Over the past decade alone, increases in annual private college costs have fluctuated between 5 percent and 8.6 percent. Increases in tuition at public universities have fluctuated even more.

To understand just how big a difference this fluctuation makes in a family's financial planning, consider a young couple saving for their newborn child's college costs. If tuition and fees at a private university keep rising at the same rate they have over the last few years, parents with a new child today will have to come up with just over $100,000—in today's dollars—when that child heads off to college. If those costs rose two percentage points faster than today's pace, more like the average increase since 1980, the tab would be over $150,000. Two points less than today's rate of increase would mean about $75,000. This kind of uncertainty is enough to make any soccer mom's financial planning difficult, to say the least.

So while families face the anxiety of uncertain tuition prices and, in any case, find it increasingly difficult to pay for college without straining their budgets to the hilt, the cost of not going to college makes these tremendous sacrifices difficult to avoid.

What makes matters worse is that federal programs meant to assist students facing steep college costs have themselves added to the rise in tuition. Starting with passage of the Higher Education Act of 1965 (HEA), the federal government has guaranteed student loans extended by private banks. The Student Loan Marketing Association (Sallie Mae) was established in 1972 as a government-sponsored enterprise to establish a secondary market in student loans. In addition, a limited direct government loan program was established in 1993. These loan programs not only facilitate indebtedness, but also boost the scale of that indebtedness by encouraging steeper tuition increases. As Thomas Donlan recently wrote in Barron's, "The faculty and staff can vote themselves higher salaries and more resources if the only consequence is that students and parents just have to sign on the dotted line to borrow some more money." With federal debt assistance so readily available schools have no incentive to control the costs of education.

On top of all this is the convoluted federal tax code that penalizes students and parents who work hard and save for college. In some cases, students saving for their college years are hit with an effective marginal tax rate of over 65 percent.

Consider the case of Lee Hurst of Tarkio, Missouri who spent her high school years raising cattle through the 4-H program and selling homegrown aster flowers to the local greenhouses. For every dollar Lee earned she is forced to pay 15 cents in federal income taxes and 15 cents in Medicare and social security taxes. So right away, Lee is only able to save 70 cents for every dollar she faithfully puts away for her education. Then, the nominal interest (inflation and all) on Lee's savings is taxed at 15 percent. Finally, when college time rolls around and Lee applies for any federal financial aid she will find that her eligibility is limited because she has worked hard and saved her own money. Add all these taxes up and Lee is paying more than 65 cents in "taxes" for every marginal dollar she has saved, a higher marginal tax rate than even Bill Gates faces.

No wonder families are finding paying for college such a headache.

Any plan meant to help parents and students preparing for college must (1) help families control the costs of college and (2) remove some of the anxiety that arises from constantly fluctuating tuition prices.

President Clinton, to his credit, has recognized the difficulties American families face. Unfortunately, the president's solution is like the old story that a good punch to the stomach is enough to make someone forget about their headache. The plan—inappropriately titled the HOPE scholarship—would solve neither the high cost nor uncertainty of college costs; in fact, the administration's plan would make matters worse.

Specifically, the president's proposal would create greater inflation in tuition costs; not address the uncertainty of future college expenses; benefit relatively few families; subject parents and students to undue scrutiny by the Internal Revenue Service; and complicate further an already overbearing tax code.

**President Clinton's HOPE scholarship, a $1,500 tax credit for the first two years of higher education, would further inflate tuition costs for all students.** In effect, the president's plan would make students and parents indifferent to additional tuition increases of up to $1,500 because the federal government is picking up the tab. This detrimental effect has been noted by many observers from across the ideological spectrum including *Reason* magazine and the American Association of State Colleges and Universities.

**President Clinton's HOPE scholarship would benefit relatively few families and students.** Lawrence Gladieux, the executive director of policy analysis at the College Board, and Robert Reischauer, a senior fellow in economic studies at the Brookings Institution and former director of the Congressional Budget Office, believe that most of the benefits from the president's plan would go to families of students who would have attended college anyway. And even those low-income families that would benefit from the HOPE scholarship simultaneously would be hurt because they would be disqualified—dollar for dollar—from other needs-based assistance. So, the population of families and students that would benefit from President Clinton's proposal is relatively small.

On the other hand, the number of children whose families would likely benefit from the creation of tax-free higher education savings accounts would be roughly 19 million. (Please see Appendix II for a state-by-state analysis) This population far exceeds that covered by the president's plan.

**Perhaps the most disturbing aspect of President Clinton's proposal is that the $1,500 tax credit depends on a student maintaining a B average or better.** This would significantly increase grade inflation. Universities would be loath to give out any grades lower than a B knowing full well that students (and ultimately the school) would lose the federal tax credit. Moreover, the grade requirement represents an unfair intrusion into the lives of American families. As if it were not enough that families are now required to report every detail of their

financial lives to the Internal Revenue Service (IRS), President Clinton's plan would have them send along their children's report cards.

**Finally, the President's plan introduces yet another complexity into the already convoluted and unfair federal income tax code.** In poll after poll, Americans record the complexity of the federal income tax as a major concern. The costs of this complexity are enormous. Each year Americans spend more than 5.4 billion hours and $157 billion filling out their federal tax forms. President Clinton's plan would add to this complexity by carving out yet another tax credit that would require additional paper work and additional forms.

In short, the administration's higher education proposal does nothing to control the high costs of college tuition; does not remove the anxiety families feel when faced with uncertain future tuition rates; and would actually increase the intrusive nature of the existing federal income tax code.

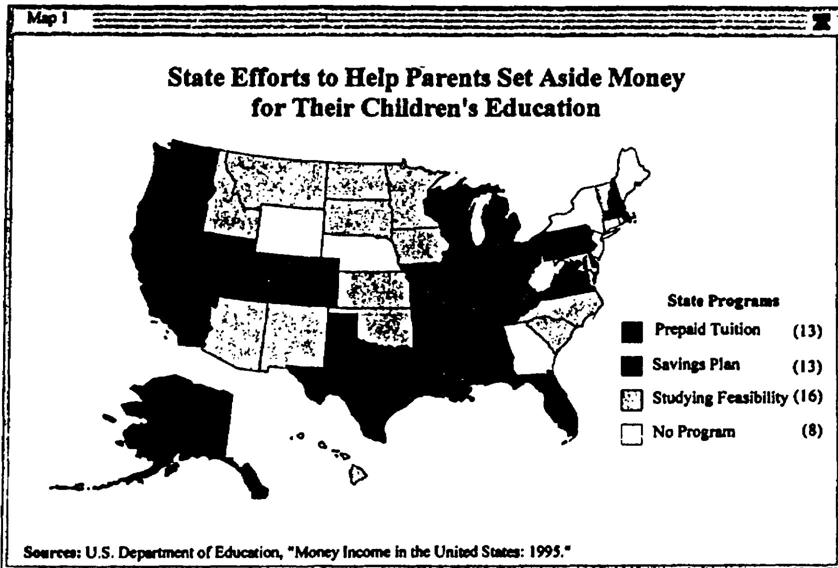
The alternative is to begin the process of getting to the root of the problems that currently exist and not add injury to insult. Mr. Chairman, it's time to stop penalizing families and students who work hard and save for college. I encourage you to allow families and students to save for higher education tax-free.

Title III of S. 1, "The Safe and Affordable Schools Act of 1997," does just that by creating tax-free higher education savings accounts. With a few minor clarifications, the approach adopted in Title III of S. 1 will give parents and students who work hard and save for college the break they so desperately deserve. Specifically,

**First**, Title III of S. 1 would make the buildup of earnings in state-sponsored tuition savings plans completely tax-free.

Today, 42 states either have implemented some form of tax-favored education savings plan or are studying the feasibility of such a program. (Please see map 1 and Appendix I for details) These programs range from simple savings trust funds that allow parents to save whatever amount they wish, without having to pay state income taxes on the earnings, to complex pre-paid tuition plans that allow parents to purchase a unit of education (say a semester) at a school within the state at a specific date in the future. As Peter Mezereas, Executive Director of the Massachusetts plan, explains, "These plans are a way to lock in tomorrow's tuition at today's rates."

The state plans are a wonderful example of federalism at work because each plan is designed differently depending on the demographic composition of the state and the institutional structure of the state's higher education system. This effort should be afforded the maximum amount of latitude as states continue to refine their programs and more states establish new ones. The best way to do this is to make the buildup of earnings in state-sponsored tuition savings plans completely tax-free. This would also benefit the families and students that have invested for their college education through the state-sponsored savings plans.




**Second,** Title III of S. 1 permits parents and students to establish a tax-free higher education savings account. Similar to a super IRA, contributions to a tax-free higher education savings account would be made in after-tax dollars and withdrawn by the student completely tax-free. Also, and most importantly, each tax-free higher education savings account could contain several different investment vehicles just as any specific IRA may contain holdings in several different mutual funds. This is important because it allows parents the flexibility to diversify their college savings but always maintain tax-free earnings on the account as a whole.

**Third,** Title III of S. 1 could be easily modified to allow for individual savings vehicles to be transferable between two higher education savings accounts. Again, this is very important because it grants families the freedom to tailor their savings plans to their changing needs.

For example, a private higher education bond market may develop. One family may purchase a pre-paid tuition bond to Wilmington College in Delaware and another family may purchase a pre-paid tuition bond to Columbia University in New York. If the student of the family in New York decides to attend Wilmington College in Delaware and the student in Delaware decides to attend Columbia then these families should be able to trade their individual assets without loosing the tax-free status. Families and students who have worked hard and saved for college should not be locked into a specific school or school system.

In such a market, independent investors or schools would offer bonds denominated in education units (semesters or credit hours, for example) at particular schools. Parents could purchase the bonds for the year in which their child was expected to enter college. But there would be an additional choice. A parent could buy a "call" option at a small price for the right to buy a bond at a later time at a fixed price. That time might be when the family could expect a higher income, or when the parents sold their house and became "empty nesters." As with any other futures market, parents essentially would be locking in a future price without paying for the product today.

Not only would this guarantee to parents that their savings would be sufficient to pay for the educational needs of their children at a particular college, but a family could trade one bond for another bond good at a different college if the family's means or desires changed. In other words, a market would develop in which investors who hold a bond for one school could trade the bond with other investors who hold bonds redeemable at another school.

If schools themselves were the issuers of such bonds, which is a likely development, they would also benefit. By issuing bonds, schools could raise money to build additional classrooms, upgrade computer systems, or pay for any number of other capital-intensive projects. Issuing bonds would be an attractive offer to schools that otherwise would have to borrow money from a bank or solicit private donations. The bondholders also would represent a pool of potential future students.

A higher education bond market is only one possibility. If Congress and the President were to extend tax-free status to such a broad class of savings vehicles and allow the transferability of these assets then the possibilities available to students and parents would be limitless. In fact, some private savings instruments have developed already. For example, the College Savings Bank of Princeton, New Jersey, offers the CollegeSure® Certificate of Deposit (CD), a federally insured savngs vehicle whose rate of return is tied to an index of the tuition inflation at 500 public and private colleges and universities. The CollegeSure® CD is more flexible than the state plans because the savings can be used at any school in the United States and can be applied toward tuition, room, board, or any other cost associated with a student's education. Because the CD is indexed, the purchaser knows the investment will cover average increases in college costs—though it does not lock in a specific amount of education at any particular institution.

I also recommend removing the restriction currently in Title III of S. 1 that only cash contributions can be made to a student's tax-free higher education savings account. Think, for example, about a grandparent who bought stock in a company many years ago and now wants to donate this stock to their grandchild's education account. We should not penalize such charity.

Finally, I would recommend removing the annual $1,000 limit placed on contributions to each individual tax-free higher education savings account if for no other reason than to allow for the possibility of scholarships. Perhaps a local Kiwinis club would like to create a scholarship for the community's most active youngster by purchasing a pre-paid tuition contract to a local

college. Such a scholarship (whose value would likely be greater than $1,000) would be transferred to the winner in a single year. Again, we should not penalize such activity.

These are just a few of the many possible innovations that may evolve in the private market for helping parents and students meet the tremendous costs of a college education. The key is to make all savings for higher education tax-free and therefore extend the maximum amount of freedom to the families of the more than 19 million children who work hard and save for their children's college costs.

Thank you again, Mr. Chairman, and I look forward to your questions and comments.

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# Appendix I

Table 1

## State Efforts to Help Parents Set Aside Money for Their Children's Education

| State | Program Name | Year of Start | Program Type |
|---|---|---|---|
| Alabama | Prepaid Affordable College Tuition (PACT) | 1990 | Prepaid Tuition |
| Alaska | University of Alaska Advance College Tuition Payment Plan | 1991 | Prepaid Tuition |
| Arizona | | | Studying feasibility |
| Arkansas | Arkansas College Savings Bond Program | 1991 | Savings Plan |
| California | | 1991 | Savings Plan |
| Colorado | Colorado Student Obligation Authority | 1997 | Prepaid Tuition |
| Connecticut | | | |
| Delaware | Family Account for College Tomorrow (FACT) | 1997-98 | Savings Plan |
| Florida | Florida Prepaid College Program | 1988 | Prepaid Tuition |
| Georgia | | | |
| Hawaii | | | Studying feasibility |
| Idaho | | | Studying feasibility |
| Illinois | Illinois College Savings Bond Program | 1988 | Savings Plan |
| Indiana | Indiana Education Savings Authority | 1996 | Savings Plan |
| Iowa | | | Studying feasibility |
| Kansas | | | Studying feasibility |
| Kentucky | Kentucky Educational Savings Plan Trust | 1990 | Savings Plan |
| Louisiana | Louisiana Student Tuition Assistance & Revenue Trust Program | 1997 | Savings Plan |
| Maine | | | |
| Maryland | | | Studying feasibility |
| Massachusetts | U-Plan - The Massachusetts College Savings Program. | 1995 | Prepaid Tuition |
| Michigan | Michigan Education Trust | 1988 | Prepaid Tuition |
| Minnesota | | | Studying feasibility |
| Mississippi | Mississippi Prepaid Affordable College Tuition Program (MPACT) | 1997 | Prepaid Tuition |
| Missouri | | | Savings Plan |
| Montana | | | Studying feasibility |
| Nebraska | | | |
| Nevada | Zero Coupon Bonds for Nevadans | 1993 | Savings Plan |
| New Hampshire | NH College Savers | 1990 | Savings Plan |
| New Jersey | | | |
| New Mexico | | | Studying feasibility |
| New York | | | |
| North Carolina | | | Studying feasibility |
| North Dakota | | | Studying feasibility |
| Ohio | Ohio Tuition Trust Authority | 1989 | Prepaid Tuition |
| Oklahoma | | | Studying feasibility |
| Oregon | | | Savings Plan |
| Pennsylvania | Pennsylvania Tuition Account Program | 1993 | Prepaid Tuition |
| Rhode Island | | | Studying feasibility |
| South Carolina | | | Studying feasibility |
| South Dakota | | | Studying feasibility |
| Tennessee | Tennessee BEST | Pending | Prepaid Tuition |
| Texas | Texas Prepaid Higher Education Tuition Program (TOMORROW) | 1996 | Prepaid Tuition |
| Utah | Utah Educational Savings Plan Trust | 1996 | Savings Plan |
| Vermont | | | Studying feasibility |
| Virginia | Virginia Prepaid Education Program (VPEP) | 1996 | Prepaid Tuition |
| Washington | | 1997 | Savings Plan |
| West Virginia | | | |
| Wisconsin | EdVest Wisconsin (Wisconsin Education Investment Program) | 1997 | Prepaid Tuition |
| Wyoming | | | |

Source: College Savings Plans Network.

## Appendix II

| State | Children (aged 1-15) who would likely benefit from tax-free Higher Education Savings Accounts (on the basis of 1996 data) |
|---|---|
| Alabama | 253,898 |
| Alaska | 56,137 |
| Arizona | 251,211 |
| Arkansas | 166,727 |
| California | 2,666,376 |
| Colorado | 288,475 |
| Connecticut | 334,688 |
| DC | 32,613 |
| Delaware | 57,646 |
| Florida | 765,178 |
| Georgia | 478,546 |
| Hawaii | 114,026 |
| Idaho | 68,810 |
| Illinois | 1,048,537 |
| Indiana | 375,256 |
| Iowa | 191,962 |
| Kansas | 212,731 |
| Kentucky | 249,821 |
| Louisiana | 311,671 |
| Maine | 53,565 |
| Maryland | 455,027 |
| Massachusetts | 544,730 |
| Michigan | 847,102 |
| Minnesota | 333,754 |
| Mississippi | 200,062 |
| Missouri | 446,771 |
| Montana | 65,109 |
| Nebraska | 131,789 |
| Nevada | 100,668 |
| New Hampshire | 62,997 |
| New Jersey | 562,655 |
| New Mexico | 113,652 |
| New York | 1,457,429 |
| North Carolina | 385,014 |
| North Dakota | 65,596 |
| Ohio | 993,652 |
| Oklahoma | 234,573 |



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| | |
|---|---|
| Oregon | 199,560 |
| Pennsylvania | 897,479 |
| Rhode Island | 69,164 |
| South Carolina | 220,099 |
| South Dakota | 54,521 |
| Tennessee | 375,135 |
| Texas | 1,269,907 |
| Utah | 161,675 |
| Vermont | 50,512 |
| Virginia | 377,669 |
| Washington | 312,427 |
| West Virginia | 103,254 |
| Wisconsin | 458,156 |
| Wyoming | 20,500 |
| **United States** | **19,545,276** |

Technical note: The number of children who will likely benefit from the Heritage proposal is based on the 1996 Current Population Survey. Specifically, the percentage of people age 17 to 21 who are currently enrolled in a college or university was applied to the total population of children age 1 to 15 years old. Therefore this should be considered a static estimate based on the historical rate of college enrollment.

# NAST

National Association of State Treasurers

**TESTIMONY**

**of the**

**COLLEGE SAVINGS PLANS NETWORK**

**presented by**

**MARSHALL BENNETT**

**State Treasurer of Mississippi**

**regarding**

**Education Tax Proposals**

**before the**

**Committee on Finance**

**U.S. Senate**

**April 16, 1997**

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*Introduction*
*The College Savings Plans Network*

Mr. Chairman and Members of the Committee, I am Marshall Bennett, the State Treasurer of Mississippi, Administrator of the Mississippi Prepaid Affordable College Tuition Plan ("MPACT"), and member of the Executive Committee of the College Savings Plans Network ("CSPN"). CSPN was formed in 1991 as an affiliate to the National Association of State Treasurers. CSPN is a national association which represents the common interests of state-operated prepaid tuition plans. The primary mission of the Network is to encourage families to save ahead for college. To accomplish its mission, the College Savings Plans Network shares information among existing programs, provides information to other state agencies which are interested in starting a college savings program, and monitors federal activities and legislation affecting state programs. CSPN welcomes the opportunity to discuss sound methods to improve access to postsecondary education.

The rising cost of higher education is one of the major concerns facing American families today. These costs have risen sharply in the last 15 years. According to the U.S. General Accounting Office, since 1980, tuition at 4-year public colleges and universities increased 234 percent. In contrast, median household income rose by only 82 percent. As a result, the portion of a household's income needed to pay for college tuition nearly doubled during the period. Rising tuition rates force families to resort to loans to fund their children's college education. During the 15-year period, the U.S. Department of Education's loan portfolio increased from $2.2 billion to $11.5 billion. Not only are more loans being taken out, the size of the loans has increased. In 1980, the average loan size for a four year college was $518. In 1995, the same type of loan was $2,417. At the same time, the value of a college education grew, increasing the demand for college enrollments. The constantly rising costs coupled with higher demand create uncertainty for families who want to send their children to college.

Ensuring access to postsecondary education is high on the agenda of the Congress and the White House. The Administration, recognizing the uncertain availability and affordability of a higher education in today's environment, submitted several proposals in its Fiscal Year 1998 budget designed to reduce the financial barriers to higher education. Education initiatives also are high on the Republican agenda, including S. 1, the Safe and Affordable Schools Act. CSPN is very pleased to receive Chairman Roth's support for proposed legislation to encourage college savings. As Senator Roth noted in a recent editorial, ". . . I can think of no tax that makes less sense than one that stands in the way of our children and a prosperous future. Taxing prepaid tuition plans just does not add up." The College Savings Plans Network applauds these efforts to improve access to postsecondary education.

*College Tuition Plans*
*Promote Savings*

The best answer to soaring college costs is to encourage advance family savings. Student financial aid programs are clearly endangered, as over dependence on financial aid has caused the total annual cost of federal financial aid, originally targeted to help lower-income families, to rise at an unsustainable rate. Budgetary constraints force the federal government, as well as state governments, to reduce direct student financial aid. As government financial aid is reduced, the responsibility for funding college falls more directly on families. The well documented low savings rate in the U.S. also clearly indicates that additional incentives are required to get families to start saving for their children's college education.

Qualified state college tuition plans are an convenient method for many families to fund the high costs of college. The plans are designed to encourage early college savings and promote future access to higher education for children of middle-class families. The basic premise of these programs is that they encourage families to purchase future college tuition at an actuarially determined cost based on today's prices. Thus, qualified state college tuition plans act as a catalyst for college savings. Families participating in the programs save specifically for college where frequently otherwise they would not set aside money for this purpose. The programs also raise attention to the need to save for college. As a result, they provide a unique psychological benefit because they guarantee to cover future and by providing parents with permanent assurance about their children's future.

*College Savings Plan Programs*
*An Overview*

States have long worked to identify ways to encourage citizens to attend college. For example, since 1959, New Jersey has offered college savings bonds to its citizens to encourage enrollment. As concerns about the affordability of college grew in the 1980s, states established a variety of college savings programs to assure access to higher education. The first prepaid college tuition plan was established by Michigan in 1986. Alabama, Florida and Ohio followed between 1988 and 1989. Since 1989, there has been moderate growth in the number of programs, due principally to uncertainty over the federal tax treatment of the programs. Legislation approved last year under the bipartisan leadership of the Finance Committee, we believe, is encouraging many more states to set up these plans. Currently, every state has implemented or is considering implementing a college savings program.

***Prepaid College Tuition Plans***

The prepaid college tuition programs share a clear mission: to actively encourage early planning and the advance purchase of tuition to maximize opportunity for higher education. In brief, under prepaid college tuition plans, purchasers pay in advance for educational benefits that a designated beneficiary is expected to use in the future at participating institutions, usually in-state public colleges. The programs pool all payments into one large fund and invest it with the goal of achieving a rate of return that is higher than the rate of tuition increases anticipated at the participating colleges. When the beneficiary enrolls at a participating college, the programs pay to the school the current rate for tuition and fees. Prepaid tuition plans permit parents and grandparents to lock in current tuition rates in return for a guarantee of college tuition at any of the state's participating colleges or universities or, in certain programs, an equal payment to private and out-of-state institutions.

Generally, contributors pre-purchase either full tuition coverage or units of future tuition costs through lump-sum purchases or various installment plans. The programs charge roughly current prices for tuition and fees, but the prices normally are adjusted annually to account for increases in college costs. Some programs offer payroll deductions or electronic fund transfers as payment options. Dollars contributed to the plans are held in state trust funds which make long-term investments so that earnings meet or exceed the inflationary rise of college tuition. In addition, various refund provisions may apply if the beneficiary cannot use the benefits due to death or disability; chooses to not go to college; or attends an out-of-state college or proprietary college. The programs generally do not guarantee that the beneficiary will be accepted for enrollment at one of the participating colleges. However, under certain plans, new beneficiaries may be named in place of the original one. Finally, in the case the fund becomes actuarially unsound, most states have built an escape clause into their plans that would allow them to end the program and issue refunds to the participants.

Although each state's college savings plan is unique, taking into account the needs and circumstances of the state, there are several features common to state-operated college savings plans:

- The plans are statutorily created;
- The plans are administered by the state and/or governed by a Board appointed by the state and comprised of state officials and others;
- State personnel operate the plans, which are governed by strict financial and program accountability requirements;

- The plans are limited to prescribed investment policies and standards;

- All state citizens may participate in the plans, but state plans are generally restricted to state residents;

- The savings provided by the plans are dedicated to the provision of higher education, with prescribed limitations governing the return of savings or prepayments only in the event of such circumstances as death, permanent disability; or the failure of the beneficiary to meet entrance requirements; and

- The plans generally include a refund provision for beneficiaries who choose not to matriculate.

## *Management and Operation of Qualified State Tuition Plans*

Although the form and management of each state prepaid tuition plan reflects the needs and circumstances of each state, the plans share certain management and oversight features. The plans are administered by state entities, variously called boards, authorities, or trusts. These entities are responsible for operation of the funds and for oversight of the strict investment policies which govern the moneys contributed to the funds. By statute, most of the operating authorities are required to follow prudent investment practices to maximize the total return on investment and to ensure that the investments meet the future obligations of the funds. In addition, many of the funds are required to follow detailed asset allocation rules to ensure diversity of investment, and are subject to outside audits to confirm the safety and soundness of the funds. Many operating authorities also have discretion to contract out management and operational services, and several are authorized to purchase third-party insurance to ensure the value of the assets contributed to the programs.

Program administrators consider advertising and marketing a critical factor in maximizing participation. The programs employ a wide a variety of methods to reach potential participants, including mass mailings to elementary and middle schools, distribution of information flyers in hospital maternity wards and doctors offices, information videos distributed for free at libraries and video outlets, radio and television announcements, newspaper announcements, "piggyback" mailings in other agencies' official mailings, and various grassroots outreach, such as booths at school and youth fairs or trade shows.

*A Current Profile of the State Plans*

Fifteen states actively operate qualified college tuition plans. (Alabama, Alaska, Florida, Indiana, Kentucky, Massachusetts, Michigan, Mississippi, Ohio, Pennsylvania, Colorado, Texas, Utah, Virginia, and Wyoming.) Another four states -- Louisiana, Tennessee, Washington, and Wisconsin -- are in the process of implementing college savings plans. Every remaining state, except Georgia, which operates the lottery funded the HOPE scholarship program, has legislation pending or is actively studying the establishment of a prepaid college tuition plan. Several states, including Maryland, have passed legislation that is awaiting enactment by the Governor. These plans are expected to be operational by the end of the year.

Currently, there are over 600, 000 signed prepaid tuition contracts, and a higher number of designated beneficiaries within the existing active programs. The estimated fair market value of these contracts is over $3 billion. The exact totals for the number of contracts and participants are not available because several of the programs are currently in their peak spring open enrollment periods. However, the numbers of participants and contracts are expected to show healthy growth this year. CSPN expects over one million contracts/participants in the programs by the end of 1999. These figures reflect the strong support by state residents who are diligently saving for the college education of their children or grandchildren.

*Current Federal Tax Treatment*

A key provision of the Small Business Job Protection Act of 1996 clarified the tax treatment of contributions made to prepaid plans. Prior to the 1996 law change, the treatment of redeemed contributions was not clear. The Internal Revenue Service considered implementing rules which would have treated the prepaid contracts as a form of contingent debt instrument because, like bonds, they mature at a certain future date. The IRS proposed to tax participants in prepaid programs annually on "phantom" income earned on prepaid accounts. However, because the beneficiaries in most cases are children, the earnings would generally not be large enough to result in a tax liability. Moreover, the inconvenience to participants and the costly paperwork involved in annual income reporting would substantially reduce popularity of the plans. Indeed, the uncertainty with the law is the principal reason for the slow growth in the number of plans, as well as the previous slow growth in the number of plan participants.

Working closely with the College Savings Plans Network and the National Association of State Treasurers, the 104th Congress passed section 529 of the Internal Revenue Code. The new section clarified the federal tax treatment of qualified state tuition plans and outlined the qualifications required to establish the tax-exempt status of the state agencies which administer the programs. Section 529 also clarified the tax-deferred status of earnings, and set the policies and procedures related to the refund of the account if the beneficiary dies before distribution of the funds.

Under the 1996 Act, the federal income tax obligation on contributions to a qualified state college tuition plan is deferred until the contributions are redeemed. Upon redemption, the applicable tax is levied on the student who benefits from the plan, not the contributor. The federal income tax is due on the difference between the current value of the contributions and their original cost. As a result, the accrued interest income is taxed at the beneficiary's rate. The annual increase in value is not subject to annual capital gains tax. In addition, no gift tax is incurred upon a contribution to a prepaid college tuition account, but a gift tax may apply to amounts used for college or otherwise distributed.

The College Savings Plans Network strongly supported these changes because they make participation in the plans more attractive to families. Since the passage of these provisions, nearly all states which previously did not have plans or were studying their feasibility have moved forward with positive steps to implement the programs. Indeed, with many state legislatures currently in session, new plans are being approved almost every day.

***Proposals to Clarify the Current Tax Treatment of Qualified State College Tuition Plans***

State college savings plan administrators welcomed the clarification of the federal tax status of the plans, but believe additional legislation is necessary to increase the attractiveness and marketability of the plans. Two proposals currently under consideration would further enhance the attractiveness by clarifying the tax treatment of distributions from the plans and making other techrical changes. The College Savings Plans Network commends Chairman Roth and Senators Coverdell, Graham and McConnell for their leadership in offering these proposals.

***S. 1 - The Safe and Affordable Schools Act***

The Senate Republican Leadership placed proposals to increase access to higher education at the top of the Senate's agenda. On January 21, 1997, Senator Paul Coverdell introduced S. 1, the Safe and Affordable Schools Act. Title III of the bill includes a number of proposals to revise tax provisions relating to education and training. For example under the bill, distributions made by a qualified state tuition program to a designated beneficiary to cover qualified higher education expenses would not be included in the gross income of the beneficiary or contributor to the program. However, any distributions not used for qualified expenses in excess of the contributions would be included in the gross income of the beneficiary. Similarly, any refunds received by the contributor in excess of the contributions would be included in the gross income of the contributor. The bill would also expand the definition of qualified education expenses to include room and board expenses.

***McConnell-Graham College Savings Act of 1997***
***Would Clarify Section 529***

Under legislation to be introduced today by Senators McConnell and Graham, distributions from a state fund used for qualified education purposes would be tax-free to the student. In addition, the legislation would expand the definition of qualified higher education expenses to cover room and board. The legislation would also permit the transfer of plan benefits to cousins and step-siblings, permit states to include private colleges and universities in their prepaid tuition programs, and allow states to establish scholarship programs within a prepaid tuition or savings plan. Finally, the McConnell-Graham bill would clarify the transition rules enacted in 1996.

***The Proposals Increase Incentives***
***for College Savings***

The Safe and Affordable Schools Act and the McConnell-Graham College Savings Act of 1997 properly focus on increasing the attractiveness of the college savings plans currently in operation or under consideration by the states. Under current law, the taxation of distributions creates a disincentive to participate in the plans because potential participants may not understand or be receptive to paying taxes on income they had not personally received, but which is used to pay qualified education expenses. Program sponsors are concerned that this disincentive hinders maximizing participation in the programs. Program sponsors are also concerned that possible requirements to notify taxpayers of the tax on certain distributions may create costly administrative burdens for the plans.

In addition, under current law, room and board, books, and transportation and other costs are not eligible. However, these costs may account for up to half the cost of a current education. Including room and board as a qualified educational expense is desirable because this would reduce the need to have separate savings for to cover these costs.

***Conclusion***

CSPN believes promoting greater access to higher education and encouraging savings over debt is sound public policy. The existing prepaid tuition programs encourage savings and may reduce the need for financial aid and subsidized student loans. As a result, the limited amounts of financial aid can be focused to directly benefit lower income students. Moreover, these programs enable more young Americans to go to college and secure higher paying positions, providing a better educated workforce. The College Savings Plans Network urges the Committee to amend current tax law to help encourage families to plan, prepare, and save rather than rely on student loans or financial aid to educate their children. CSPN strongly supports and endorses the legislative proposal of Senators Coverdell, McConnell and Graham. Eliminating all federal

income taxes on the accrued interest earned through the state programs would create an additional incentive for college savings.

The College Savings Plans Network commends Chairman Roth and Senators McConnell and Graham for their leadership on these proposals. CSPN encourages the Committee include these college savings-related tax issues in the Fiscal Year 1998 Budget Reconciliation bill or any other tax legislation to be considered by the Committee in 1997.

Thank you very much for the opportunity to share CSPN's perspective on the benefits to American families of prepaid college tuition plans. I would be pleased to answer any questions.

Testimony of
David W. Breneman
University Professor and Dean
Curry School of Education
University of Virginia

Before the Committee on Finance
United States Senate
April 16, 1997

Mr. Chairman, I welcome the opportunity to comment on the administration's proposals for a HOPE scholarship tuition tax credit and an education and job training tax deduction. I comment from the vantage point of an economist who studies higher education finance, and who has served as president of a private college and as dean within a public university.

College affordability is a well-documented concern of many middle and upper income families, as well as for low income families. Education and training are essential for young people of today if they are to have productive and prosperous lives. The entire nation clearly will benefit from increased investment in higher education, and thus I am supportive of the motivation behind these proposals. My concern, however, is that the consequences may not be what the administration claims for these programs. Indeed, I will argue that the result of this legislation will be increased aid for institutions of higher education, rather than tax relief for families. While increased institutional aid may be money well spent, that case should be made directly on its own merits, and not by indirection.

One of the common criticisms of tuition tax credits or deductions for families with incomes up to $100,000, is that behavior is not changed, i.e., students from these families would enroll in any event, and thus the tax benefit is a windfall to the families, a deadweight loss to society. In this instance, however, behavior would be affected, but it would be institutional behavior that would change, not student behavior. Let me explain.

A high percentage of the students who would be covered by these tax benefits would be applicants for student financial aid, institutional aid as well as federal and state aid. Responsible officials in college student aid offices are trained to identify and include all potential resources available to applicants before awarding the institution's own funds as grant aid. Student aid offices also have available detailed financial information on students who apply for aid, so a reasonably accurate estimate could be made for each student of the likely tax benefits made possible by each of these programs. The result will be an additional calculation for each student in the relevant income range, estimating either the value of the credit or the deduction to that family. At many colleges, the aid office, acting responsibly as

steward of the institution's own funds, will then reduce institutional aid that might have been awarded by the maximum estimated tax relief available to the family. The credit or deduction will thus function as an indirect form of aid to institutions, reducing their own aid outlays by the amount of the tax benefit.

It should be noted that, in the case described above, the actual posted tuition rate need not increase for the institution to benefit. In essence, what happens is that the net tuition charge to students will increase by the amount of the estimated tax benefits, where net tuition is the actual amount paid by the student after deducting financial aid. In the simplest case of the full $1,500 tax credit, the institution will assume that amount as available to the family, and reduce its own award by $1,500, causing the student's net price to be $1,500 more than it would have been in the absence of the credit. This mechanism will operate to some extent for all students eligible for either the credit or the deduction, and who also apply for student financial aid.

There are institutions that award little financial aid from their own resources, and where the above process would not operate as described--these are primarily public two-year colleges, some public four year colleges with very low tuition, and many proprietary schools. For these institutions to benefit from the proposed tax legislation, their posted tuition prices would have to increase, i.e., the increase in net tuition is not available to them. The temptation to capture the tax credit or deduction is certainly present, but the outcome is not quite so clear in this case. Public sector tuitions are politically determined prices, and often involve negotiation with the governor, the legislature, or the state coordinating board. Political factors can thus offset economic forces, producing analytical uncertainty. It is not hard to imagine, however, that state officials will see the tax credit and deduction as an opportunity to raise tuition over time, while reducing state appropriations, thereby shifting costs from state to federal budgets. Jawboning from the federal level may be the only way to resist such moves, but it seems unwise to rely on rhetoric to produce the desired outcome.

Let me turn now to another way to think about these tax proposals. When a tax credit or deduction is being proposed as an alternative to a direct expenditure program, it seems reasonable to ask whether one would support the tax proposal if it were presented as a direct outlay. The attached table compares the distribution of Pell grants, loan subsidies, tax credit, and tax deduction, by income class, for students attending two-year and four-year public colleges and four-year private institutions. To my eye, the pattern of benefits displayed in this table fails both efficiency and equity tests. The Pell Grant program has the merit of targeting aid to students for whom the aid makes a difference, i.e., those students who would be unable to attend college without the grant. Does anyone really believe that a tax credit (or grant)

of $1,500 would make a difference in the college-going decision of a student from a family with $80,000 annual income? The forgone revenue devoted to either the credit or the deduction could buy much more college access if it were used to expand the Pell Grant program.

These considerations would be academic if the Pell Grant program were fully funded and delivering the opportunity that it did at its beginning, but that is not the case.[1] Pell Grants have been underfunded by roughly $6 billion, and thus the forgone revenue caused by the proposed tax expenditures comes at a significant opportunity cost to the major access program of the federal government. Whatever the merits of tax relief to middle and upper income families (ignoring for the moment the earlier argument that little of that benefit would actually accrue to families), one has to weigh that benefit against what a comparable sum could do if allocated to increased Pell Grants. I submit that direct expenditure on Pell Grants is superior on both economic criteria of efficiency and equity.

A word should be said about the financial concerns of middle and upper income parents that have motivated the tax relief proposals. Families in these income categories need reasonable ways to finance the cost of college more than they need the modest subsidies of the tax credit or deduction proposals. The expansion of Stafford and PLUS loans have done much to meet these financing needs, and plans that encourage savings for college or make available pre-paid tuition futures are developing rapidly and further assist families with their college financing needs. These approaches strike me as far more responsive to the real needs of middle and upper income families than the Clinton tax proposals.

I am reminded in the current context of the circumstances that led to the passage of the Middle Income Students Assistance Act in 1978. At that time, the Congress was motivated by a desire to help middle income students finance higher education. One of the principal features of that act was to eliminate any income test for the Guaranteed Student Loan (GSL) program. The result was an upsurge of borrowing by middle and high income families, using the funds borrowed to arbitrage against the much higher interest rates available in the market. In other words, families borrowed at the GSL rate of 8 percent, and invested their own funds at the much higher interest rates then prevailing. Having realized this mistake, Congress subsequently undid the damage, but only after considerable needless cost to the Treasury. I see the same situation developing in this current attempt to aid middle and high income families, and I urge the Congress to think carefully before committing a similar mistake.

Thank you for giving me the opportunity to share these thoughts with you.

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[1]On this point, see David W. Breneman and Fred J. Galloway, "Rethinking the Allocation of Pell Grants," in U.S. Department of Education, Financing Postsecondary Education: The Federal Role, Proceedings of The National Conference on the Best Ways for the Federal Government to Help Students and families Finance Postsecondary Education, U.S.G.P.O., 1996, pp. 23-30.

## Pell Grants, Loan Subsidies and Proposed Tax Benefits for Freshmen, by Family Income

### 2-Year, Public Institutions

| Family Income[1] | Pell Grant[2] | Loan Subsidy[3] | Tax Credit[4] | Tax Deduction[5] |
|---|---|---|---|---|
| $10,000 | $3,000 | $200 | $0 | $0 |
| 20,000 | 3,000 | 200 | 0 | 150 |
| 30,000 | 2,450 | 310 | 0 | 150 |
| 40,000 | 950 | 610 | 50 | 150 |
| 50,000 | 0 | 0 | 1,000 | 150 |
| 60,000 | 0 | 0 | 1,000 | 280 |
| 70,000 | 0 | 0 | 1,000 | 280 |
| 80,000 | 0 | 0 | 1,000 | 280 |
| 90,000 | 0 | 0 | 500 | 140. |
| 100,000 | 0 | 0 | 0 | 0 |

Tuition=$1,000,Cost of Attendance=$4,000

### 4-Year, Public Institutions

| Family Income | Pell Grant | Loan Subsidy | Tax Credit | Tax Deduction |
|---|---|---|---|---|
| $10,000 | $3,000 | $875 | $0 | $0 |
| 20,000 | 3,000 | 875 | 0 | 450 |
| 30,000 | 2,450 | 875 | 0 | 450 |
| 40,000 | 950 | 875 | 550 | 450 |
| 50,000 | 0 | 875 | 1,500 | 450 |
| 60,000 | 0 | 0 | 1,500 | 840 |
| 70,000 | 0 | 0 | 1,500 | 840 |
| 80,000 | 0 | 0 | 1,500 | 840 |
| 90,000 | 0 | 0 | 750 | 420 |
| 100,000 | 0 | 0 | 0 | 0 |

Tuition=$3,000,Cost of Attendance=$10,000

### 4-Year, Private Institutions

| Family Income | Pell Grant | Loan Subsidy | Tax Credit | Tax Deduction |
|---|---|---|---|---|
| $10,000 | $3,000 | $875 | $0 | $0 |
| 20,000 | 3,000 | 875 | 0 | 520 |
| 30,000 | 2,450 | 875 | 0 | 1,500 |
| 40,000 | 950 | 875 | 550 | 1,500 |
| 50,000 | 0 | 875 | 1,500 | 1,500 |
| 60,000 | 0 | 875 | 1,500 | 2,080 |
| 70,000 | 0 | 875 | 1,500 | 2,800 |
| 80,000 | 0 | 875 | 1,500 | 2,800 |
| 90,000 | 0 | 875 | 750 | 1,400 |
| 100,000 | 0 | 875 | 0 | 0 |

Tuition=$20,000,Cost of Attendance=$27,000

Data compiled by the Brown Center for Education Policy, The Brookings Institution.

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[1] Note: Family income is AGI for joint-filers with two dependents.

[2] Numbers are for families of four with both parents working, and only one child in college.

[3] Numbers based on subsidized loan of $2,625.

[4] [Tuition or Credit (whichever is smaller)] - Pell Grant amount.

[5] [Tuition or $10,000 (whichever is smaller)] - marginal tax rate.

# Statement by Senator Paul D.Coverdell

Thank you Mr. Chairman. I am pleased to have the opportunity to visit with you and the other distinguished members of the Finance committee.

If I might, Mr. Chairman -- I recognize that your jurisdiction deals with the tax consequences, but I think a brief overview of S.1 is in order.

First, S.1 has a provision that deals with drugs and violence in schools and offers, through a pilot program, families the option of escaping from certifiably violent and drug-ridden schools. It provides local schools incentives to make their school districts safer and freer of violence.

It does have a number of provisions that make higher education more affordable and I will come to that section in just a moment. One of the central provisions of the legislation, Mr. Chairman, is to eliminate among the most egregious mandates Washington has imposed on the educational system and local communities through the imposition of the 1975 legislation on special education, "IDEA". S.1 over a period of six years, eliminates that mandate by funding the Federal portion of IDEA that was originally envisioned to be 40 percent of the cost. The Federal Government has never honored the commitment and is only funding approximately 7 percent.

The last provision deals with the promotion of adult education and family literacy. So, S.1 is a broad ranging educational act.

I would simply say, Mr. Chairman, that with 40 percent of American students in elementary and secondary education fearful for their safety, with 60 percent of them arriving to college unable to effectively read, and with 20 percent of them bringing a weapon to school, we have a serious problem with regard to the nation's ability to be educated.

And I might say, Mr. Chairman, that one of the guarantors of American freedom is an educated people.

With regard to the tax provisions, both the administration and the Senate leadership have put forth comprehensive education proposals. While we agree on the need to assist families with college costs, we differ in our approach.

The administration would provide large tax credits and tax deductions which critics argue will primarily benefit those students already attending college. S.1 would provide a long-term savings incentives to help families prepare for their childrens' future costs. The program would not expire and would have a six-year cost of $1.8 billion.

The administration proposal would provide credits for current or immediate tuition costs. Experts argue that increased government tuition subsidies result in tuition cost increases. S.1 contains a long-term savings plan that would not be tied to current tuition costs.

The President's proposal links receipts of his hope Scholarship to student performance.

A child would only be eligible for the tax benefit if maintained a "B" average. Critics are arguing that that puts in motion grade inflation. S.1 does not punish working or hard-working average students. None of the tax incentives in our bill place a judgement on academic achievement. We leave those matters to the family and to the college.

Under the Presidents's plan, students become ineligible if their grades drop or if they commit a drug offense. Since the benefits come through reduced taxation, the IRS would have to monitor the students's performance and behavior. S.1 would use the current tax system to provide credits and incentives. Eligibility for the benefit would be determined by law and not subject to school grading systems.

Under the administration's proposals, government control is the focus: Hope scholarships -- government monitors the academic and personal behavior of the student. Direct lending changes -- the government control over college loans is increased at the expense of the private sector, and college loan forgiveness benefits -- available to students who work in charitable and government programs like the administration's new literacy program.

S.1 does not increase government control. It allows families to save. It gives families the option of investing in a state college savings program or to save on their own to send their child to an in-state or out-of-state school; it allows the private sector and the States to help families with college costs; and it encourages employers to provide education assistance to their employees.

Mr.Chairman, since the introduction of S.1, I have identified several suggestions that the Committee may want to consider. While our focus has been on college affordability, for reasons of efficiency it makes sense to help families addresses K-12 education costs within the same savings accounts. I suggest that S.1 be modified to:

1. Expand the Dole Accounts to allow for withdrawal of savings, with the interest tax free, to pay costs associated with K-12 school choice (tuition, books, transportation) or to pay the direct educational costs associated with home schooling (ie. books, testing).

2. Allow the Dole savings accounts to be transferred to another child without the interest being taxed or a penalty levied, as long as the funds are used for K-12 or higher education expenses.

3. Allow regular IRA funds to be withdrawn without penalty and the interest accrued to be tax free, if the funds are used to pay for K-12 school choice related costs.

By combining all of these K-12 and higher education goals in one package we can help families in an efficient and cost effective manner.

With that, Mr.Chairman, I conclude my remarks. I hope that I have kept within the time frame of this committee. Thank you for the hearing on S.1 and the opportunity to testify before you today.

**Statement of Senator Lauch Faircloth**
**Education Tax Proposals**
**Senate Finance Committee**
**April 16, 1997**

Thank you Mr. Chairman for the opportunity to present testimony before the Senate Finance Committee on education tax proposals. I had wanted to speak on the issue of education tax proposals because I, along with Senators Craig, Reid and Jeffords, have introduced a bill, S. 50, to provide for a $1,500-a-year tax credit for students attending two-year schools.

I usually do not agree with President Clinton on policy matters. However, this is one occasion where I do agree. President Clinton, in this year's State of the Union Address, proposed that $51 billion be spent on education in his "Call to Action for American Education." One of the principles in this plan is his Hope Scholarship proposal. President Clinton proposes two years of a $1,500 tax credit for college tuition, enough to pay for the typical community college.

I agree that we should afford this opportunity to all adult Americans. On January 21, I introduced S. 50 which provides for a $1,500-a-year tax credit for students attending two-year schools. S. 50 will encourage workers in all age brackets to pursue an education beyond high school without incurring the costly expenses of attending a 4-year college. By improving the training and skills of our workers, we will create better jobs in manufacturing and technology throughout the United States, nothing more important to keeping competitive in these industries in the global marketplace.

While I agree with President Clinton's basic proposal, I disagree with the requirements needed to be met to receive the tax credit. I also disagree with the proposed ways to pay for the tax credit.

President Clinton's Hope Scholarship makes some short-sighted and burdensome requirements. First, it only will credit $1,500 for full-time students. Any part-time student will only have the availability of $750 per year. My proposal allows for $1,500-a-year for full-time and part-time students as long as the student is making sufficient academic progress towards a degree or certificate or the course of study is contributing to the student's employability skills.

Second, President Clinton's proposal requires that the student maintain a "B"average during the first year of schooling to qualify for the tax credit for the second year. This grade requirement has two pitfalls. One, most community college students have full-time responsibilities such as jobs and families. These individuals may not be able to maintain a "B" average in their studies. President Clinton's proposal would penalize border-line students who were not able to achieve the required 3.0 average. Two, this requirement is administratively burdensome. Who will be certifying that these grades are correct to the IRS?

My bill makes the tax credit available to everyone who is maintaining the required minimum GPA where that student is enrolled. A "student in good standing" should be all that is academically required in order to be eligible for a tax credit.

Finally, I disagree with the ways President Clinton has proposed to pay for the tax credit. His funding sources come from three areas: an international departure tax; a reduction in the sales source rule benefits; and be auctioning the radio DARS Spectrum. The tax credit I propose will not be paid by any new taxes. It will be paid for by eliminating the wasteful administrative expenses at the Department of Education. There are millions of wasteful expenditures from that agency and others that could fund this positive initiative.

As state Commerce Secretary for North Carolina, I attracted more than 500,000 jobs into the state by strengthening our community college systems and offering custom-training for workers in specific skills. In the past eights years, North Carolina has been among the top three states in new-plant locations and gained a toehold in the film industry which now invests $2.5 billion a year in the state.

I agree with President Clinton that we must make a community college education available to all our citizens. But I believe that we must do it for the job training needed in this country. As we move more and more people off welfare and ask that they seek employment, we must provide the training and skills that are essential to these jobs. My bill will accomplish this.

Thank you for the opportunity to testify. I hope that careful consideration is given to this important initiative.

STATEMENT OF U.S. SENATOR BOB GRAHAM

before the

Committee on Finance

U.S. Senate

Education Tax Initiatives

April 16, 1997

Mr. Chairman and Members of the Committee:

I appreciate the opportunity to discuss initiatives designed to promote obtaining a college education. Later today, Senator McConnell and I, along with numerous co-sponsors both on and off the committee, will introduce the College Savings Act of 1997. This bill would clarify the tax treatment of state-sponsored prepaid college tuition and savings programs in a manner that would allow states flexibility to offer their citizens plans to pay for college on a tax-free basis.

**The Genesis of State Tuition Programs: Rising Cost of College Education**

Why are we here discussing these programs? Because they have flourished in the face of spiraling college costs. According to the General Accounting Office, tuition at public universities has increased 234% since 1980. During the same period, the general rate of inflation has increased only 85% and household income has increased only 82%. That means higher education inflation is almost triple the rate of general inflation and the increase in Americans' ability to pay.

The cause of this dramatic increase in tuition is the subject of significant debate. But whether these increases are attributable to increased costs to the universities, reductions in state funding for public universities, or the increased value of a college degree, the fact remains that affording a college education has becoming increasingly difficult.

**States Response: Prepaid Tuition and Savings Plans**

Although the federal government has increased its aid to college students over the years, it is the states who have engineered innovative ways to help its citizens afford college. Michigan

implemented the first plan in 1986. Florida followed in 1988. Today 15 states offer plans and four more will inaugurate plans this year. Almost every state government is currently considering legislation to establish such a program.

From these state laboratories, two types of programs have emerged: prepaid tuition programs and savings programs. Under either type, a family pays money now into a state fund that in future years will be transferred to colleges to pay for the child's college education. The state pools the funds from all participants and invests them in a manner that will match or exceed the rate of higher education inflation.

Under a prepaid tuition plan, the state and an individual enter into an advanced tuition payment contract naming a student as the beneficiary of the contract. The amount the family must pay depends on the number of years remaining before the student enrolls in college. In most states, purchasers can choose a lump sum payment or installment payments. Twelve states currently follow this model.

Under a state savings plan, individuals transfer money to a state trust, which in turn invests the funds and guarantees a certain rate of return. Typically, the earnings on the accounts are exempt from state taxation. Three states follow this model.

### States Tailor Programs To Their Citizens' Needs

One of the beauties of these programs is that, just as states establish institutions of higher education to meet the education needs of their states, each state program differs in its emphasis. For example:

* The Alaska plan allows individuals to direct a portion of state oil revenues to pay for their contracts.

* In Alabama, money can be used to take accredited college courses while a student is still in high school.

* The Massachusetts Plan allows non-residents to enroll in its plan.

* Louisiana provides matching grants for certain low-income participants in its plan.

### The Tax Problem: Should Participants Be Taxed?

Until 1996, the federal tax treatment of these plans remained murky. In the spring of 1996, the IRS indicated its intent to tax families annually on the earnings on funds transferred to these state plans. I thought that was wrong. So, I worked with Senators McConnell, Breaux, Shelby and the leaders of the Finance Committee to address the issue in the Small Business Job Protection

Act of 1996. The provisions we developed were included in the bill that President Clinton signed into law. The four basic provisions were:

1. Any prepaid or savings entity established by the state is tax-exempt.

2. Earnings on monies transferred to these state programs are not taxed until distribution.

3. Upon distribution, the appreciation on contracts or accounts will be taxed to the student beneficiary over the time the student attends college.

4. These tax rules applied only to contracts and accounts used to fund the costs of tuition, fees, books and required equipment.

Despite the fact that I offered the proposal in the Finance Committee, I have always thought that the right answer was that participation in these programs should be 100% tax free. In other words, no taxation upon distribution unless the funds are not used for qualified educational purposes.

**1997 Proposal: McConnell-Graham College Savings Act**

The legislation that Senator McConnell and I will introduce today will amend section 529 of the tax code in two significant respects. First, the bill provides that if distributions from a state fund are used for qualified higher education purposes, then there would be no taxation to the student. In other words, there would be no federal income tax for participation in state-sponsored plans.

Second, the bill would expand the definition of qualified higher education expenses. Last year's legislation provided that tuition, books, fees, supplies and equipment required for attendance at college can be paid for with funds from a tax-deferred state tuition plan. The McConnell-Graham bill would include costs of room and board as qualified education expenses eligible for tax treatment under section 529.

The bill also makes a number of technical and other changes to ensure that states have sufficient flexibility to run successful programs.

**Policy Reasons To Enact The Legislation**

I would like to outline five reasons we should enact legislation to clarify the federal tax treatment of these programs.

1. Congress should support state innovation. Here is an example of a national problem that the states are trying to address. During the late 1980s and early 1990s, when the federal government response to spiraling college costs was inadequate, states experimented and

engineered these programs. The federal government should encourage the states by getting the IRS out of the way.

2. State plans increase college enrollment, especially among low and middle income families. Experience demonstrates that the discipline and security offered by these programs provides the exact incentive that many low and middle income families need to save for college. For example, in Florida, the median income of families with college students is $50,000. But over 70% of Florida's participants have family income of less than $50,000.

3. State plans help prepare students psychologically. A family that regularly sets aside money for a child's college education converts the focus of the student from "whether I will be able to go to college" to "which college I will attend."

4. Savings is superior to debt. A prepayment or savings plan is better economically both for the family and the nation. And these programs can boost the nations' savings rate. For example, Virginia's program just completed its inaugural enrollment season and signed contracts for over $200 million in savings.

5. Expansion of programs will promote downward pressure on tuition rates. Increased participation in state tuition programs not only will provide participants with a guaranteed hedge against education inflation, but also will produce downward pressure on tuition rates for all students at all colleges._ States sponsoring these programs in essence guarantee that if earnings on the funds do not exceed increases in tuition rates, then the state will fund the difference when the student enrolls in college. Thus, a state has an incentive to encourage cost efficiency throughout its state system. The pressure also will promote moderate tuition hikes at private schools that compete with public colleges for students.

I urge my colleagues in the Finance Committee and the Senate to join Senator McConnell and me to ensure enactment of this legislation.

Reasons To Support

## The McConnell-Graham College Savings Act of 1997

The McConnell-Graham bill would clarify the taxation of state-sponsored prepaid college tuition and savings plans while giving states sufficient flexibility to design their programs to meet the needs of their citizenry. The two key provisions of the bill are:

1. **No Taxation.** Participants would not be taxed on any earnings on monies transferred to the state if the distributions are used for qualified college costs.

2. **Room and Board.** States would have the flexibility to provide the same tax treatment for room and board contracts and accounts as they can for tuition contracts and accounts.

Some of the reasons to support the legislation include:

**Support State Innovation.** Fifteen states have engineered these innovative programs to help their citizens deal with spiraling higher education inflation. The federal government should encourage the states by getting the IRS out of the way.

**Increases College Enrollment, Especially Among Low and Middle Income Families.** Experience shows that the discipline and security offered by these programs provides the incentive that many low and middle income families need to afford college. In Florida, although the median income of families with college students is $50,000, over 70% of participants in the state tuition program have family incomes of less than $50,000.

**Prepares Students Psychologically.** A family that is regularly setting aside money for a child's college education converts the focus of the student from "whether I will be able to go to college" to "which college I will attend."

**Savings Is Better Than Debt.** A savings plan is better economically both for the family and the nation. Virginia's program just signed contracts for over $200 million in savings in its first enrollment period.

**Promotes Downward Pressure on Tuition Rates.** Increased participation in state tuition programs not only will provide participants with a guaranteed hedge against higher education inflation, but also will produce downward pressure on tuition rates at all colleges. States sponsoring these programs will guarantee that if earnings in the funds do not exceed increases in tuition rates, then the state will fund the difference. Thus, the state has an incentive to encourage cost efficiency throughout its state system. For private schools that compete with public schools for students, this pressure also will promote moderate tuition hikes.

## CHRONOLOGY

### Federal Tax Treatment of State Tuition Programs

| | |
|---|---|
| 1986 | Michigan begins first prepaid college tuition program. |
| 1988 | The IRS issues a private letter ruling to Michigan concluding that (1) the Michigan Trust is a taxable entity, (2) participants should not be taxed until the funds are distributed from the trust, and (3) the beneficiary should be taxed on appreciation in the count upon distribution. |
| Fall 1994 | Michigan appeals the ruling that the Michigan Trust is a taxable entity and wins in the Sixth Circuit Court of Appeals. |
| Spring 1996 | The IRS contacts six states with pending private letter rulings and informs them that the IRS intends to issues adverse rulings. Specifically, IRS officials said that the ruling would conclude that (1) the state fund that invests the participants' monies is a taxable entity and (2) participants would be taxed annually on the earnings on the amount transferred to the state fund. |
| June 4, 1996 | Senator McConnell and nine Senate colleagues send letter to Senator Shelby asking for moratorium on IRS regulations and rulings dealing with the tax treatment of prepaid college tuition and savings programs. |
| June 11, 1996 | Facing a Senate Finance Committee mark-up on the Small Business Job Protection Act, the IRS reverses course, announcing that it will not issue any rulings while they study the issue. |
| June 12, 1996 | The Senate Finance Committee includes in its mark-up a provision offered by Senators Graham and Breaux to clarify the tax treatment of state tuition programs. In general, the proposal followed the IRS ruling originally issued to Michigan as modified by the Sixth Circuit:<br>• Tax-exempt status for qualified state tuition programs.<br>• Deferral of federal income tax until distribution of monies from the state fund.<br>• Taxation of appreciation to the student beneficiary.<br>• Benefits of the bill limited to qualified higher education costs, defined as tuition, books, fees, and required equipment. |
| August 20, 1996 | President Clinton signs into law the Small Business Job Protection Act of 1996, which includes the provisions included in the Finance Committee mark-up. |
| April 16, 1997 | Senators McConnell and Graham introduce bipartisan legislation to make state tuition programs totally tax-free and expand eligible costs to include room and board. |

## SUMMARY

College Savings Act of 1997

Senator Bob Graham
Senator Mitch McConnell

The McConnell-Graham bill would clarify the federal tax treatment of state-sponsored prepaid college tuition and savings programs. Enactment of the bill would allow states to offer tax-free plans, rather than tax-deferred plans, to their citizens.

### Eliminates Taxation Upon Distribution For Education Purposes

Under current law, when a state tuition program distributes funds to a college or individual to pay for qualified higher education expenses, the beneficiary (student) is taxed on the amount the state earned on funds the participant transferred to the state. The student pays tax pro rata over the years he or she attends college. The McConnell-Graham bill would eliminate this tax where the student uses the funds for qualified educational expenses.

### Clarifies That Programs May Cover Room and Board

Under the bill passed last Congress, the deferred tax treatment applies to qualified higher education expenses, which is limited to tuition, fees, books, and required equipment. The tax treatment of state program contracts and accounts for room and board remains unclear. The McConnell-Graham bill would clarify that tax code section 529 also applies to these room and board contracts and accounts.

### Makes Technical and Other Changes

The McConnell-Graham bill corrects technical errors made in the Small Business Job Protection Act of 1996 and makes other changes, including provisions to clarify that a state may include proprietary schools in its program, to allow transfer of benefits to a participant's cousin, step-brother and step-sister, and to clarify that states may establish scholarship programs within their plan.

April 16, 1997

Summary

McConnell-Graham College Savings Act of 1997

Background

The Small Business Protection Act of 1996 contained several provisions concerning state sponsored prepaid tuition and college savings plans. The principal provisions are

(1) Tax-Exempt Fund. A state tuition plan meeting the requirements of the statute is a tax-exempt entity

(2) Tax Deferred. Taxation on any appreciation on monies transferred to such a plan are tax deferred while the funds are held in the state program

(3) Student Taxed. The beneficiary (student) is taxed on such appreciation upon distribution of the funds from the state program

(4) Tuition and Fees. The tax treatment outlined above applies to programs which cover tuition, fees, books and costs directly related to course studies. Room, board, and other college costs are not covered.

McConnell-Graham Bill

This document summarizes the major provisions of the College Savings Act of 1997, to be introduced by Senators McConnell and Graham the week of April 7, 1997.

**Subsection (a) - Eliminate Taxation of Students.** Subsection (a) of the bill provides that if distributions from a state fund are used for "qualified higher education purposes", then there would no taxation to the student. This means that families participating in these state-sponsored plans and using the funds for qualified educational purposes would pay no federal income tax.

**Subsection (b) - Expand Law to Include Room and Board.** Current tax code section 529 applies only to tuition, books, fees, supplies and equipment required for attendance at college. Section 2 of the McConnell-Graham bill would expand this definition to include costs of room and board. Under the bill, the definition would be tied to costs of attendance as defined in section 472 of the Higher Education Act of 1965.

**Subsection (c)(1) - Allow Transfer of Benefits to Cousins, Step-Brothers and Step-Sisters.** Current law allows the limited redesignation of beneficiaries if the original designee fails to enroll in college. The new designee must be a member of the beneficiary's family. Generally, family members include a parent, grandparent, spouse, child of the beneficiary or the beneficiary's spouse, brother, sister, or spouse of the beneficiary's brother or sister.

Some states expressed concern that cousins and step-siblings are not included in the definition. The bill would expand the definition of family members to include these categories.

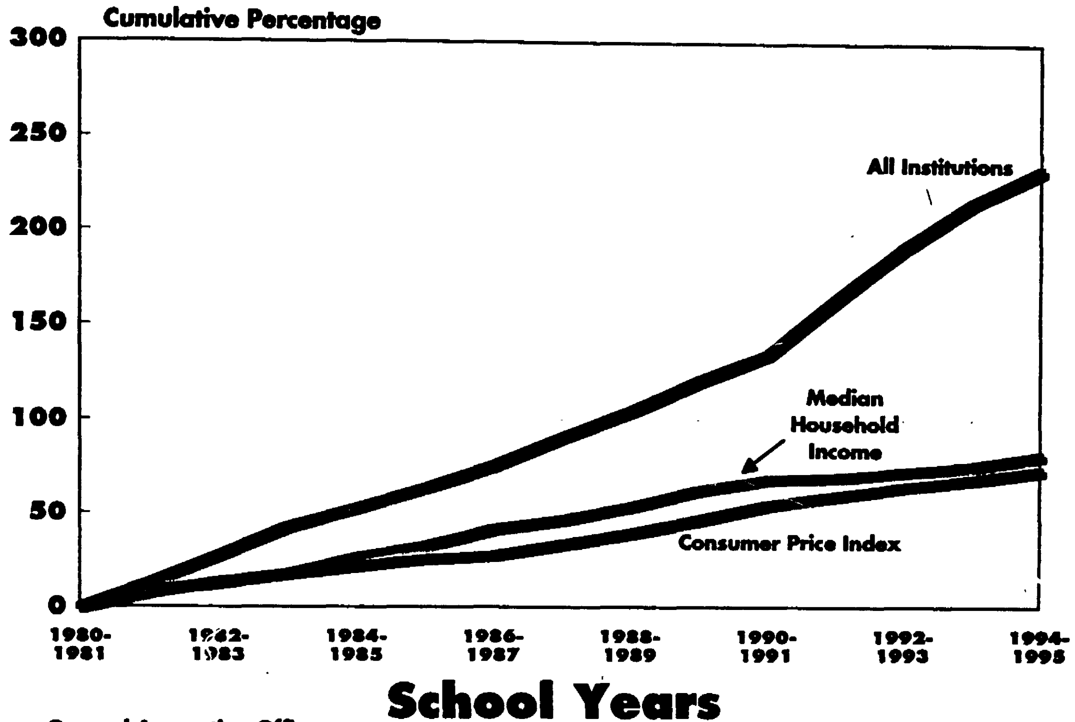
**Subsection (c)(2) - Permit States to Include Proprietary Schools.** Current law provides that the benefits from a state program may be used only at eligible educational institutions. The definition of an eligible educational institution excludes proprietary schools. The McConnell-Graham bill would allow states discretion to extend eligibility to proprietary schools.

**Subsection (c)(3)(B) - Clarify That State Plans May Establish Scholarship Programs.** Section 529 allows a state government or 501(c)(3) organization to establish a scholarship program within the state prepaid tuition or college savings plan. Some states have sought clarification as to whether the state prepaid program or savings plan itself may set up a scholarship program. The McConnell-Graham bill would clarify the appropriateness of such scholarship programs.

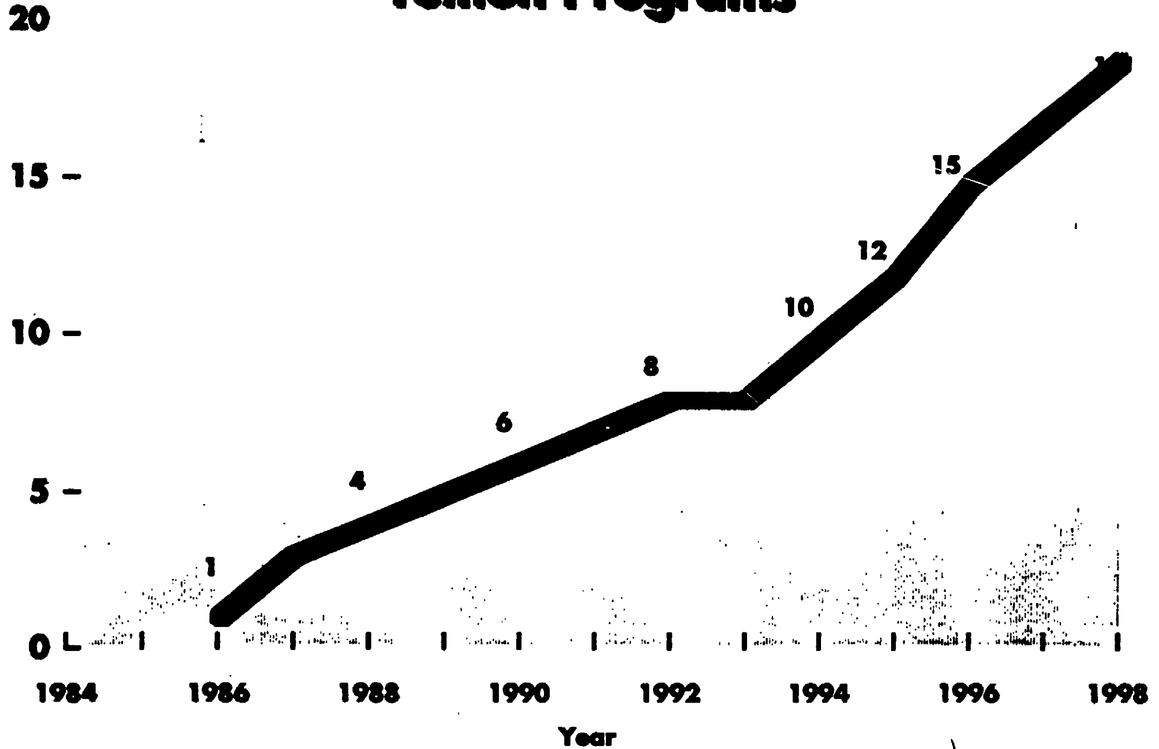
**Subsection (c)(3)(C) - Clarify Transition Rule.** The Small Business Job Protection Act provided that the benefits under section 529 may apply to contributions and earnings on such contributions made before the state comes into compliance with the new section 529. Some states have asked for clarification regarding Congress' intent with respect to contributions and earnings after August 20, 1996 (date of enactment of section 529) pursuant to contracts entered into before August 20, 1996. The McConnell-Graham bill would clarify that the transition rule would apply to contributions and earnings made post-August 20, 1996 pursuant to contracts signed before August 20, 1996.

**Subsection (d) - Coordination with Education Savings Bonds.** The bill permits bond holders to contribute EE savings bonds to qualified state tuition programs. This will ensure bond holders the flexibility to enroll in state programs.

## Increases in Tuition Have Consistently Outpaced Both Inflation and Household Income




Source: General Accounting Office


Progression of Prepaid College Tuition Programs
20
15
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1986
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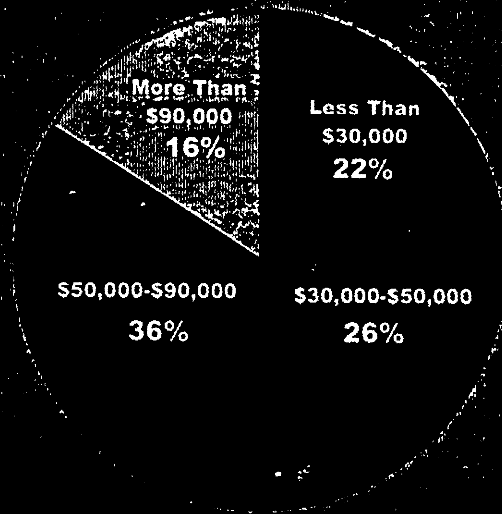
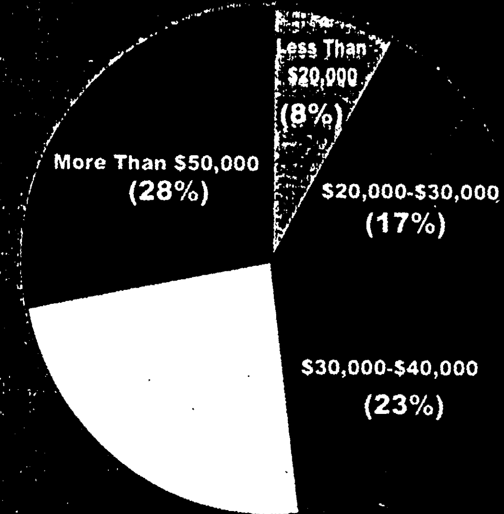
1998
Year


Who Goes to
College in Florida?
More Than
$90,000
16%
Less Than
$30,000
22%
$50,000-$90,000
36%
$30,000-$50,000
26%


Who Buys Contracts for
Florida's Prepaid College
Tuition Program?
Less Than
$20,000
(8%)
More Than $50,000
(28%)
$20,000-$30,000
(17%)
$30,000-$40,000
(23%)

# State Tuition Programs

- States that operate tuition programs
- States that have implementation pending
- States where legislatures have taken steps to initiate tuition programs

# *The College Savings Act*

**Senate Finance Committee Hearing**
**Afternoon Press Conference**
**April 16, 1997**

## Senate Sponsors

Mitch McConnell (R-KY)
Bob Graham (D-FL)

## Senate Co-Sponsors

Robert Bennett (R-UT)
John Breaux (D-LA)
Thad Cochran (R-MS)
Paul Coverdell (R-GA)
Alfonse D'Amato (R-NY)
Mike DeWine (R-OH)
John Glenn (D-OH)
Kay B. Hutchison (R-TX)
Mary Landrieu (D-LA)
Connie Mack (R-FL)
Frank Murkowski (R-AK)
Chuck Robb (D-VA)
Richard Shelby (R-AL)
Arlen Specter (R-PA)
John Warner (R-VA)

## State Finance Officials

***The Honorable Georgie Thomas***
Treasurer, State of New Hampshire
President, National Association of State Treasurers

***The Honorable Marshall G. Bennett,***
Treasurer, State of Mississippi
Administrator, Mississippi Prepaid Affordable College Tuition Plan

## Pre-Paid Tuition Plan Participants

***Mr. Sean Gilliland***
Senior, University of Florida
Major in Business Administration and East Asian Studies

***Mr. Patrick Gilliland***
Junior, University of Florida
School of Health and Human Performance

***Mrs. Aniko Nole***
Recently Widowed, Has Eight-Year-Old Son
Fairfax County, Virginia

54-642 99-4

# *State Pre-Paid Tuition Programs/Savings Plans*

| State | Type of Plan | Number of Contracts | Year of Inception | Program Director |
|---|---|---|---|---|
| **Alabama** | Pre-Paid | 42, 999 | 1990 | Paul Stevenson (334) 242-7408 |
| **Alaska** | Savings | 13, 340 | 1990 | Jim Lynch (907) 474-7711 |
| **Florida** | Pre-Paid | 425, 804 | 1987 | Bill Nichols (904) 488-8514 |
| **Kentucky** | Savings | 2, 620 | 1988 | Jo Carole Ellis (502) 564-5668 |
| **Louisiana** | Savings | Starts 7/97 | 1997 | Jim Lynch (907) 474-7711 |
| **Massachusetts** | Pre-Paid | 33, 405 | 1995 | Peter Mazares (617) 261-9760 |
| **Michigan** | Pre-Paid | 56, 015 | 1986 | Robin Lott (517) 335-4767 |
| **Mississippi** | Pre-Paid | 7, 642 | 1996 | M. Bennett (601) 261-9760 |
| **Ohio** | Pre-Paid | 57, 950 | 1989 | B. Jennings (614) 752-8988 |
| **Pennsylvania** | Pre-Paid | 17, 884 | 1992 | Joseph Rice (717) 772-4948 |
| **Utah** | Savings | 203 | 1996 | Norm Tarbox (801) 321-7251 |
| **Virginia** | Pre-Paid | 16, 111 | 1994 | Diana Cantor (804) 786-0719 |

*Lawrence E. Gladieux*
*And Robert D. Reischauer*

# Higher Tuition, More Grade Inflation

*Tuition tax breaks would be bad fiscally and worse educationally.*

More than any president since Lyndon Johnson, Bill Clinton has linked his presidency to strengthening and broadening American education. He has argued persuasively that the nation needs to increase its investment in education to spur economic growth, expand opportunity and reduce growing income disparities. He has certainly earned the right to try to make education work for him as an issue in his reelection campaign, and that's clearly what he plans to do.

Unfortunately, one way the president has chosen to pursue his goals for education is by competing with the GOP on tax cuts. The centerpiece of his education agenda—tax breaks for families paying college tuition—would be bad tax policy and worse education policy. While tuition tax relief may be wildly popular with voters and leave Republicans speechless, it won't achieve the president's worthy objectives for education, won't help those most in need and will create more problems than it solves.

Under the president's plan, families could choose to deduct up to $10,000 in tuition from their taxable income or take a tax credit (a direct offset against federal income tax) of $1,500 for the first year of undergraduate education or training. The credit would be available for a second year if the student maintains a B average.

The vast majority of taxpayers who incur tuition expenses—joint filers with incomes up to $100,000 and single filers up to $70,000—would be eligible for these tax breaks. But before the nation invests the $43 billion that the administration says this plan will cost over the next six years, the public should demand that policy makers answer these questions:

- **Will tuition tax credits and deductions boost postsecondary enrollment?** Not significantly. Most of the benefits would go to families of students who would have attended college anyway. For them, it will be a windfall. That won't lift the country's net investment in education or widen opportunities for higher education. For families who don't have quite enough to send their child to college, the tax relief may come too late to make a difference. While those families could adjust their payroll withholding, most won't. Thus any relief would be realized in year-end tax refunds, long after families needed the money to pay the tuition.
- **Will they help moderate- and low-income students who have the most difficulty meeting tuition costs?** A tax deduction would be of no use to those without taxable income. On the other hand, the proposed $1,500 tax credit—because it would be "refundable"—would benefit even students and families that owe no taxes. But nearly 4 million low-income students would largely be excluded from the tax credit because they receive Pell Grants which, under the Clinton plan, would be subtracted from their tax-credit eligibility.
- **Will the plan lead to greater federal intrusion into higher education?** The Internal Revenue Service would have to certify the amount of tuition students actually paid, the size of their Pell Grants and whether they maintained B averages. This could impose complex regulatory burdens on universities and further complicate the tax code. It's no wonder the Treasury Department has long resisted proposals for tuition tax breaks.
- **Will the program encourage still higher tuition levels and more grade inflation?** While the tuition spiral may be moderating slightly, college price increases have averaged more than twice the rate of inflation during the 1990s. With the vast majority of students receiving tax relief, colleges might have less incentive to hold down their tuition increases. Grades, which have been rising almost as rapidly as tuition, might get an extra boost too if professors hesitate to deny their students the B needed to renew the tax credit.
- **If more than $40 billion in new resources really can be found to expand access to higher education, is this the best way to invest it?** A far better alternative to tuition tax schemes is need-based student financial aid. The existing aid programs, imperfect as they may be, are a much more effective way to equalize educational opportunity and increase enrollment rates. More than $40 billion could go a long way toward restoring the purchasing power of Pell Grants and other proven programs, whose benefits inflation has eroded by as much as 50 percent during the past 15 years. Unlike tuition tax cuts, expanded need-based aid would not drag the IRS into the process of delivering educational benefits. Need-based aid also is less likely to increase inflationary pressure on college prices, because such aid goes to only a portion of the college-going population.

Economists have long argued that the tax code shouldn't be used if the same objective can be met through a direct-expenditure program. Tax incentives for college savings might make sense; parents seem to need more encouragement to put money away for their children's education. But tax relief for current tuition expenditures fails the test.

Maybe Clinton's tuition tax-relief plan, like the Republican across-the-board tax-cut proposals, can be chalked up to election-year pandering that will be forgotten after November. But oft-repeated campaign themes sometimes make it into the policy stream. That was the case in 1992, when candidate Clinton promised student-loan reform and community service that, as president, he turned into constructive initiatives. If reelected, Clinton again may stick with his campaign mantra. This time, it's tuition tax breaks. This time, he shouldn't.

*Lawrence E. Gladieux is executive director for policy analysis of the College Board. Robert D. Reischauer is senior fellow in economic studies at the Brookings Institution and former director of the Congressional Budget Office.*

**The Washington Post**
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**TESTIMONY**
**Submitted to the**
**Committee on Finance, United States Senate**
**Hearing of April 16, 1997**

**presented by**
**Ms. Jennifer Long**
**Fourth Year Dental Student**
**State University of New York at Buffalo**

**on behalf of the**
**American Association of Dental Schools**
**and the**
**American Dental Association**

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**American Association of Colleges of Podiatric Medicine**
**American College Personnel Association**
**American Medical Student Association**
**American Optometric Association**
**American Pharmaceutical Association**
**American Podiatric Medical Association**
**American Podiatric Medical Students Association**
**American Student Assistance**
**American Student Dental Association**
**American Veterinary Medical Association**
**Association of Academic Health Centers**
**Association of American Law Schools**
**Association of American Medical Colleges**
**Association of American Veterinary Medical Colleges**
**Association of Community College Trustees**
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**Career College Association**
**Coalition of Higher Education Assistance Organizations**
**Consortium on Financing Higher Education**
**Consumer Bankers Association**
**Council for Advancement and Support of Education**
**Council of Graduate Schools**
**Education Finance Council**
**Hispanic Association of Colleges and Universities**
**National Association for College Admission Counseling**
**National Association for Equal Opportunity in Higher Education**
**National Association of Graduate-Professional Students**
**National Association of Student Personnel Administrators**
**National Association of Women in Education**
**National Council of Higher Education Loan Programs**
**National Education Association**
**National League of Nursing**
**SALLIE MAE: Student Loan Marketing Association**
**The College Board**
**United Negro College Fund**
**United States Public Interest Research Group**
**United States Student Association**

**Introduction**

My name is Jennifer Long. I am a fourth-year dental student at the State University of New York at Buffalo. It is a pleasure to present testimony today on behalf of the American Association of Dental Schools (AADS) and the American Dental Association (ADA). The AADS represents all of the dental schools in the United States, as well as advanced education, hospital, and allied dental education institutions. The ADA represents 140,000 dentists nationwide. It is within dental education institutions that future practitioners, educators, and researchers are trained; significant dental care provided; and the majority of dental research conducted. This testimony is also endorsed by the American Student Dental Association and 43 other organizations.

I am the first member in my family to receive a professional degree. I grew up in a single-parent home with a deaf parent on disability. Because I am from a family of limited means, I faced the cost of college alone. I worked very hard and I am proud that I diligently saved and worked throughout college to obtain my education. I shopped around for the best education I could afford and consequently chose to attend lower cost state supported institutions (my undergraduate degree was obtained at SUNY-Binghamton). The total cost of attendance for dental school at SUNY - Buffalo for in-state students is $88,742. Despite my efforts to save money and work hard, I am facing a mountain of debt. Upon graduation from my endeavor to become a dentist, I will owe $90,000.[1] My monthly student loan payment will average $1,100 per month. I will pay approximately $7,500 of interest in the first year of repayment. After I graduate I will return to my hometown of Binghamton, NY, where I will begin a career as a general dentist with a practice that includes service to the hearing-impaired community.

A student loan interest deduction would be especially important for heavily-indebted students like myself in the early years after graduation when earnings are low and interest makes up a greater portion of loan repayment. Student loans are generally repaid over 10 to 25 years, so that the further a student is from graduation, the less interest there will be to deduct at presumably the same time an individual's earnings are increasing. The potential individual benefit depends on the level of indebtedness. In my case, when I begin work as a general dentist in Binghamton in September, I will have a salary of approximately $2,500 per month. The monthly check to repay my student loan, just this one payment, will eat up 40 percent of my take home pay! If the student loan interest deduction is passed this Congress, I would expect to save between $1,500 and $2,000 in taxes in the first year of loan repayment. This savings could equal over six-month's worth of grocery bills and a year of utility bills. My circumstances are strikingly similar to students all across the United States who also have worked hard to earn an education and face debts that are equivalent to a home mortgage when they graduate. Like many others, I have this student loan debt burden to deal with before even thinking about the next generation. I ask myself, how can I save for my children's education when I marry (in June) and start a family when I already face a mountain of debt from my own educational endeavors?

Student loan debt burden is a serious consideration for decisions about career plans and continued studies for many students. We are concerned about growing student indebtedness and its impact on access to higher education and post-graduation career choices. Restoring a student loan interest deduction would be a critical step the government could take to assist individuals with high student loan debt. This would especially help low- and middle-income families who have to borrow to finance higher education. Low income and minority students are two groups which would especially benefit from the student loan interest deduction.

I respectfully request that Congress consider a student loan interest deduction provision in any tax legislation being considered this year, such as the proposed provisions in S. 1 and S. 12. Students nationwide are struggling with increasing student debt burdens. This is the basic reason why Congress should intervene to assist students and their families through a wise use of the tax code.

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[1] All student loan debt figures throughout the testimony refer to principal only.

**The Student Loan Debt Burden is a Serious Issue**

Students do not borrow for frivolous reasons; most students have to borrow to finance their education.[2] Their sacrifices can present a significant financial burden. Here are a few real examples from fellow students:

- Steven Lopez, a 1995 graduate of Marquette University's Dental School, has diligently been repaying his student loans while working as the director of a dental clinic in Scenic Bluffs, Wisconsin, where he cares for the low-income patient population from the surrounding farm community. Despite participation in a faculty loan repayment program for disadvantaged health professions graduates, after one year of repayment he is still $168,000 in debt from student loans. His monthly student loan payment is $850, nearly one-half of his take-home pay. In one year's time, the interest accumulated on his student loan debt is a staggering $13,000. For Dr. Lopez who has higher debt, the estimated first-year tax savings would be at least $1,950, or as much as $3,640 if the student loan interest deduction were passed.

- Marie Sackett is a senior at Evergreen State College, in Olympia, Washington. Her father died 15 years ago, leaving the family dependent on Social Security Income to survive. Marie is the first in her family to pursue a college education. Despite working throughout her school career, she has relied on student loans and the maximum Pell Grant available to pay for college. She will graduate this Spring with almost $30,000 in student loan debt ($7,500 from undergraduate student loans). Marie hopes to be a school teacher after she graduates, but will be hampered by more than $300 in monthly payments on her student loans.

- Michele DeDeo is a 4th year mathematics graduate student at the University of California at San Diego. She has been working throughout her studies to supplement her income and must delay graduation this summer due to inadequate time to perform research needed to complete her degree. Michele's loan debt stands at $40,000 and will continue to rise. The job market for teaching mathematics at the postsecondary level is not promising, but she expects to secure a job at a local private 4-year or a 2-year college where she could earn as little at $26,000 or as much at $31,000 annually. Her monthly student loan payment will be approximately $450. Over the life of the loan she could pay out as much as $14,000 in interest.

- A young couple, David Evans and Suzanne El-Attar, both graduates of the University of Pittsburgh School of Medicine in 1994, are currently third year residents in family medicine in Washington State. Both graduated with debt loads of more than $100,000, with their combined debt nearing $250,000. As such, this level of debt significantly influences their career decisions, as well as their ability to remain solvent given their debt load. As primary care physicians who want to provide service to underserved populations, large debt burdens will influence their ability to practice in underserved areas.

- Karen and Ken Tankersley are a young married couple from the Medical College of Virginia/Virginia Commonwealth University. They expect to have more than $155,000 in combined higher education debt when they graduate in May. While Karen will enter an advanced education program in general dentistry, Ken will begin a 6-year oral surgery residency. This means more accumulated debt. They worry about the mounting college loan debt and "passing on the American dream" to their children when the time comes to finance their children's educational costs.

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[2] More than 94 percent of dental seniors report using some type of loan to finance their education.

For many, a loan is the only means to finance a higher education. American college students have borrowed more in the 1990s than was borrowed by college students in the 1960s, 1970s and 1980s combined. While this does not account for inflation or other factors discussed below, it is a staggering thought. A 1995 survey found that 97 percent of American families ranked a college education as very important. Most students have been willing to incur large debt because they see it as an investment in their future financial security and in their potential for social contribution.

The amount of debt incurred by Ph.D. candidates has also increased in the 1990s. Data from the annual Survey of Earned Doctorates shows that the percentage of U.S. citizens earning Ph.D.s who have debt of $10,000 or more has increased by nearly one-quarter between 1990 and 1995. In 1990, 25 percent of U.S. citizens earning Ph.D.s had debt of more than $10,000; by 1995 this had increased to 31 percent. Moreover, disadvantaged minority groups, among the doctorate-level population, have even higher percentages with debt greater than $10,000. While 31 percent of U.S. citizen Ph.D.s had debt of $10,000 or more, 41 percent of African Americans, and 43 percent of Hispanics had student loan debt in excess of $10,000.[3]

It is a good thing that students have greater access to lower cost loans. If not for various student loan programs, most graduate-professional students could not continue their educations. Even for undergraduates, student loans fill a major gap left by inadequate resources available in the form of grants and scholarships.

The skyrocketing reliance on student loans over the past decade can be attributed to increased opportunities to borrow for school as education programs have been created, expanded, and redefined to allow more students to borrow greater amounts. Reductions in public support for state universities combined with the Pell Grant shortfall and continued overall declining support for grants and scholarships at the undergraduate level have contributed widely to an increase in student loan demand. The near decimation of teaching and research fellowships and stipends at the graduate level have forced graduate-professional students to finance their educations almost exclusively with student loans.[4]

Borrowing for college has increased at a rate nearly three times as fast as college costs and four times as fast as personal incomes. Between 1990 and 1994, borrowing grew by an average of 22 percent annually. During that same time period, costs of attendance (tuition, fees, room, and board) at public institutions increased by an average of 6.6 percent, and at private institutions by an average of 7.3 percent. Borrowing also has significantly outpaced growth in incomes. Disposable personal income per capita from 1990 to 1994 increased only 4.7 percent per year.[5]

The National Postsecondary Student Aid Survey estimates on graduating debt for 1995 - 1996 for all undergraduate four-year programs is not yet available; however, a study conducted by the Educational Testing Service found that high school seniors who were concerned about borrowing for their education were more likely to delay college, choose lower-priced schools, or not go at all. Anecdotal evidence suggests that increasing debt may also hamper students from pursuing advanced educational endeavors. Debts of more than $100,000 for health professions students are not unusual. This growing debt burden for students may discourage the pursuit of advanced degrees, especially for disadvantaged and minority students. It may also discourage graduates from taking lower-paying public service, teaching, and research positions. Health professions graduates with high debt may be deterred from careers in primary care as well as careers in a community or a public health setting. In recent years anecdotal evidence suggests this was becoming a factor

[3] These debt levels include undergraduate and graduate debt.
[4] These factors combined with the creation of the unsubsidized Stafford Loan program, a revision in the definition of an independent student, and the elimination of home and farm equity from the expected family contribution calculation, have made student loans at all levels (other than community college) synonymous with attendance.
[5] Education Resource Institute and the Institute for Higher Education Policy, "College Debt and the American Family," 1995.

as debt increased. A 1992 study of medical students found that debt was a more important factor in surgical or specialty choice for students with debt of $75,000 or more.[6]

We are particularly concerned with the impact of indebtedness on low-income and minority students. Students who often have the highest need, including older students, part-time students, and minorities, are increasing their debt levels at faster rates than other students, especially at the graduate-professional level. The most recent National Postsecondary Student Aid Study (NPSAS) found that the average annual amount of all student loan borrowing rose by 10 percent from 1990 to 1993 from $7,675 to $8,474. The NPSAS data indicated that while a 10 percent rise in borrowing can be viewed as minor, it is important to note that the increased borrowing took place among those attending public institutions, non-traditional students, and minorities. During the same time frame, full-time undergraduates saw their borrowing increase by an average of 8 percent, part-time students experienced a 17 percent increase, while older students experienced a 20 percent increase.[7]

**Examples of Graduate-Professional School Debt Burdens**

| | |
|---|---|
| **Graduate-Ph.D Students** | By 1995, 47% of all Ph.D.s reported student loan debt of $10,000 or more.[8] |
| **Law Students** | The 1995 average debt for law school graduates was estimated at $40,300.[9] |
| **Dental Students** | In 1996, average graduating debt for dental school was $75,748 (72% graduated with debt of more than $50,000).[10] |
| **Medical Students** | In 1996, median debt at private medical schools was $91,860. At public medical schools this figure was $64,275.[11] |
| **Osteopathic Medical Students** | In 1995, average indebtedness of seniors graduating from osteopathic medical schools was $90,300.[12] |
| **Podiatric Medical Students** | In 1996, the national average debt for graduates of Podiatric medicine was $123,000.[13] |

**The Student Loan Interest Deduction is a Positive Solution to Encourage Investment in Higher Education and Alleviate the Student Debt Burden**

Unless we could wave a magic wand and create hundreds of billions in additional scholarship dollars for students, the reality is that student loan debt is here to stay. It is fair to ask students to make an investment in their future. Restoration of a student loan interest deduction is an effective way to help encourage this investment while alleviating the financial burden. It also will not contribute to an increase in college costs simply because the benefit is on the back-end, meaning the student will already have expended the monies for tuition, fees, room and board, and will not realize the tax benefit until repayment. Colleges will have absolutely no incentive to raise costs if Congress were to restore such a deduction.

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[6] Kassebaum and Szenas, "Relationship between Indebtedness and the Specialty Choices of Graduating Medical Students," 67 Academic Medicine 700, 1992.
[7] Education Resource Institute and the Institute for Higher Education Policy, "College Debt and the American Family," 1995.
[8] Summary Report 1995 of Doctorate Recipients from United States Universities, Office of Scientific and Engineering Personnel, National Research Council, National Academy Press, Washington, DC, 1996.
[9] Data provided by The Access Group (a private student loan organization).
[10] Survey of Dental Seniors, 1996 Graduating Class, American Association of Dental Schools.
[11] Figures provided by the Association of American Medical Colleges.
[12] Debts and Career Plans of Osteopathic Medical Students in 1995, American Association of Colleges of Osteopathic Medicine.
[13] Figure provided by the American Association of Colleges of Podiatric Medicine.

The 1986 Tax Reform Act phased out the deduction for "consumer" interest over a 5-year period, to discourage over-reliance on credit. Unfortunately, educational loans were also included, even though they are investments in education rather than discretionary consumer borrowing. We believe that borrowing for higher education is an investment in human capital which should be treated like other capital investment. Loans used to finance an education contribute to the economic strength of this country in a significant manner.

Current law permits interest deductions for educational expenses paid for through home equity loans. This is not an option for most of the student population, and some families, who either do not own a home or do not have sufficient home equity, cannot benefit from this deduction. In fact, many students' dream of owning a home may be influenced by their student loan debt.

Our view is that a deduction for a first education is just as important as a home mortgage interest deduction for a first house **(oddly, the tax code allows individuals to deduct for a second house but not a first education!)**. Further, according to a 1995 report, a student's debt may deter them from purchasing a home early in their lives. If a borrower's debt payments, including mortgage payments, exceed 33 - 36 percent of monthly gross income, they may be denied a home loan. If student loan payments fall between a quarter and a third of a graduate's monthly income, the probability of meeting the qualification guidelines and securing a mortgage is significantly lower.[14]

Elimination of the student loan interest deduction especially hurts students from families where there is little or no excess cash to contribute to the student's education, as well as students who are financially independent and not receiving parental support for pursuing a degree. From 1990 - 1993, 57 percent of the traditional-age graduates with an undergraduate degree saw their student loan debt rise by 4 percent, while 60 percent of the non-traditional age students saw their debt increase by 20 percent.

While restoring the student loan interest deduction is neither the only solution to the growing debt problem, nor the only factor affecting career choices, it will help to make student loan repayment more reasonable and allow graduates a full choice of career options. This means entry into fields such as public health, primary care, teaching, and research, where earning potential is substantially reduced. Many Deans and Financial Aid Administrators have observed how students have altered their career choices, and ruled out certain options, based on the level of debt they will incur. Students and parents understand the concept of an interest deduction, and how it will help them with loan repayments. A dean of a professional school reported the reservations by a student's parents when they realized that the educational debt was going to be larger than the mortgage on the family house.

In most cases of students and parents with significant higher education debt, the student loan interest deduction will be beneficial. This is particularly true for parents who have several dependent children attending college at the same time. We believe that it is essential to have a student loan interest deduction as part of any higher education tax proposal, so that those with the highest debt will be assisted in a meaningful way.

## The Most Important Features of a Student Loan Interest Deduction

- An "above the line" deduction so that all students with student loan debts could benefit, not just those who itemize deductions. Additionally, an "above the line" deduction is a simple-to-use tax provision;

- Reasonable income phase-outs so that the benefit is available to lower- and middle-income students and families; .

[14] Education Resource Institute and the Institute for Higher Education Policy, "Graduating Into Debt," 1995.

- A deduction available up to the actual amount of interest, so that those with the highest debt would receive the most assistance from this provision; and

- Any limits targeted to the length of the benefit should be reasonable (i.e. at a minimum, taxpayers should be able to deduct their student loan interest for the first five years of repayment, and whether or not the years are consecutive).

To further emphasize the point, the Committee should not be concerned that this type of deduction would contribute to increasing higher education costs, a concern that has been expressed about a tuition deduction. A student loan interest deduction would benefit the borrower after the borrowing is done and education completed. It is clearly a benefit for the individual, not a college or university subsidy.

We hope Congress will maintain its commitment to helping students by passing a student loan interest deduction during the 105th Congress. Congressional activity in 1995 acknowledged the desirability of reinstating such a tax benefit, even if on a more limited basis than was available before the Tax Reform Act of 1986. The Budget Reconciliation Act that was ultimately vetoed by the President in 1995 included a student loan interest deduction provision that was championed by Senators Grassley and Moseley-Braun. At a minimum, that should be the starting point as the Committee considers higher education tax incentives this year. We recommend that a student loan interest deduction provision be implemented in a manner sensitive to minimizing revenue loss to the Treasury while helping borrowers with the most need. Additionally, we would ask that the tax deduction be crafted to be as simple as possible for the taxpayer.

## Conclusion

We urge that Congress reaffirm its recognition of, and commitment to, providing this benefit to students and parents by passing student loan interest deduction legislation in 1997. Restoring the deduction is a valid and cost-effective method for the government to encourage investment in higher education. By restoring the student loan interest deduction, the government acknowledges not only the costs incurred in making this investment, but the contribution higher education makes to society at large. Today, when technological and scientific training is critical to our world competitiveness and as we strive to become more productive as a nation, the need to invest in higher education becomes even more important to the economic future of our country. This is also the type of middle and lower income tax relief and economic incentive that encourages investment in our most important resource: people.

The student loan interest deduction would go to work immediately to support the vitally important investment in people. The deduction provides a comprehensive approach to support students and families, complementary to the goals of not only the Administration but also the Congress, in making America's workforce second to none. We believe that restoration of a student loan interest deduction is consistent with the desire of President Clinton and the Congress to promote higher education as well as to enhance the productivity of our nation.

The following organizations endorse this testimony:
Academy of Students of Pharmacy
American Association of Colleges of Nursing
American Association of Colleges of Osteopathic Medicine
American Association of Colleges of Pharmacy
American Association of Colleges of Podiatric Medicine
American Association of Dental Schools
American College Personnel Association
American Dental Association
American Medical Student Association

American Optometric Association
American Pharmaceutical Association
American Podiatric Medical Association
American Podiatric Medical Students Association
American Student Assistance
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Association of Community College Trustees
Association of Schools and Colleges of Optometry
Association of Schools of Allied Health Professions
Association of Schools of Public Health
Association of University Programs in Health Administration
Career College Association
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Consortium on Financing Higher Education
Consumer Bankers Association
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SALLIE MAE: Student Loan Marketing Association
The College Board
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United States Student Association

Money
America's Financial Adviser

Herewith the testimony of Tyler Mathisen, executive editor of Money Magazine, before the Senate Finance Committee, April 16, 1997.

Mr. Chairman.

The American dream is a brilliant, complex mosaic. And of all the pieces in it, none is more precious than a college education.

And no wonder.

Parents know that America's more than 2,100 four-year schools are a priceless national resource, a place where minds are sharpened and skills acquired. And they know that the country's roughly 1,500 two-year institutions are a jewel too, a place to polish old skills, learn income-enhancing new ones or to prepare oneself for the rigors of a four-year school or a career.

Parents also understand something far more practical—that higher learning equals higher earnings. By some estimates, Americans earn 5% to 15% more annually for every year they stay in school after high school. Some analysts calculate that the average lifetime income of a college grad is $600,000 greater, roughly 75% more, than that of an individual who merely has a high school diploma. And this earnings gap is steadily widening.

But today in America this dream of higher education is colliding with the reality of tighter budgets—federal, state and family.

It will come as no surprise to you, Mr. Chairman, that the College Board pegs the cost of a year at the average state college at $9,649 this year. At the average private school, the sticker is $20,361; and at the elites, $31,000 or more.

Granted, a minority of families pay the full list price these days. Yet the high costs, and the accelerated rises in them, pinch families hard. Costs at public and private schools are roughly double what they were a decade ago. And back then, they were roughly twice what they had been ten years before that. And those comparisons apply only to the average schools. In the mid-1970s, a

year at Harvard went for a little over $5,300, all in. This year, the cost is more than six times as much.

Since the mid 1970s, reports **Money** writer Marguerite Smith, consumer prices and the median income of American families with college-age children have roughly tripled. But the average cost of college has risen more than four-fold. Today, the average public school's $9,600 tab gobbles up well over 20% of median family income—pretax income—up from 10% two decades ago. Back in the early 1970s, a year at Harvard consumed less than one-third of median income. Today, it eats up 68% of it.

One of the singular triumphs of 20th Century America has been the democratization of higher learning. Today nearly 35% of 18-to-24-year-olds are enrolled in U.S. undergraduate programs. Thirty years ago, the comparable figure was just 25%—a 40% gain in less than a generation. For women, the progress is even more striking. Back in 1967, only 19% of females aged 18 to 24 were enrolled in college. Today, nearly double that figure—36%—are.

These numbers are critical, because I believe that the democratization of higher learning not only helps maintain our strong global competitiveness today but will ensure it tomorrow. Yet today, the average middle-class family can come up with only 30% or so of the costs of a year at the typical public college, to say nothing of what they can afford at a private or an elite school.

Moreover, this says nothing of what they may be able to afford if college costs continue to rise at 6% or 6.5% a year, roughly double the overall inflation rate.

Take a couple with a three year old child today. If they want their daughter to go to the average state school for four years beginning in the year 2012, they ought to be putting aside $182 a month in today's dollars, earning 7% after tax, to cover the full $104,000 cost of a B.A. out of savings.

If that same couple wants their little genius to attend the average private school, they need to save $401 a month, every single month through graduation day, to foot the full $228,000 cost. And if Harvard is in their sights, they need to be saving $618 a month for what by then will likely be a $350,000 four-year cost.

Think about it: $182 or $401 or $618 a month, every month, for every child in your household, until the last of them graduates from college. Could you do it? Could your son or daughter muster the discipline, not to mention the money, to do it for their kids?

Not many families can, and it's got them worried. In one 1996 poll, about four out of five Americans with kids say they fear being able to afford college in the future.

Money magazine has not taken a position on the various education tax proposals being considered by the 105th Congress, and I will not advance one today.

But I will say that for your constituents, access to higher education is now, and increasingly will become, the defining factor in whether they enjoy a bountiful standard of living or one on society's margins.

That is why helping Americans pay for higher education today, and to save for it for tomorrow, is as important a legislative goal as you will face. It affects individuals in your states. But because a highly educated workforce makes for a more globally competitive workforce, it affects us all and is therefore a vital national interest as well.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF HON. MITCH MCCONNELL

Mr. Chairman and members of the Committee, I appreciate you taking time to hold these hearings and greatly appreciate you allowing me to testify on a matter of utmost importance the education of our children. For the past several years, I have worked to make college more affordable by rewarding families who save. In both the 103rd and 104th Congresses, I introduced legislation to make earnings invested in state-sponsored tuition savings plans exempt from federal taxation. States have also recognized the needs of families and have provided incentives for them to save or prepay their children's education. State savings plans provide families, a safe, affordable and disciplined means of paying for their children's education.

According to GAO, tuition at a four-year university rose 234 percent between 1980-1994. During this same period, median household income rose 84 percent and the consumer price index rose a mere 74 percent. The College Board reports that tuition costs for the 1996-1997 school year will rise 5 percent while average room and board costs will rise between 4-6 percent. While education costs have moderated throughout the 1990's, they continues to outstrip the gains in income. Tuition has now become the greatest barrier to attendance.

Due to the rising cost of education, more and more families have come to rely on financial aid to meet tuition costs. In fact, a majority of all college students accept some amount of financial assistance. In 1995, $50 billion in financial aid was available to students from federal, state and institutional sources. This was $3 billion higher than the previous year. A majority of this increase has come in the form of loans, which now make up the largest portion of the total federal-aid package at 57 percent. Grants, which a decade ago made up 49 percent of assistance, have been reduced to 42 percent. This shift toward loans further burdens students and families with additional interest costs.

In response to this trend, Congress and the President have developed different proposals to address the rising cost of a post-secondary education. S. 1, the Safe and Affordable Schools Act, provides incentives for families to save for their children's college education through education savings accounts and state-sponsored savings plans. For those burdened by student loans, this legislation also makes the interest paid on student loans deductible. The President has offered two tax provisions, the HOPE Scholarship, which is a $1,500 tax credit and a separate $10,000 tax deduction for tuition expenses.

S. 1 makes the earnings in state-sponsored tuition savings plans exempt from taxation. This provision recognizes the leadership states have taken in helping families save for college. In the mid-80s states recognized the need of families to keep pace with the rising cost of education. States like Michigan, Florida, Ohio and Kentucky were the first programs to be started in order to help families save for college. Today, there are 15 states with programs in operation. An additional four states will implement their programs this year. Also, I am informed by the College Savings Network that every other state, except Georgia, which has implemented the HOPE Scholarship program, is preparing legislation or is studying a proposal to help their residents save for college.

Today there are 600,000 participants contributing over $3 billion to education savings nationwide. By year end, the College Savings Plan Network estimates that they will have one million participants. By 2006, they estimate that over $6 billion will be invested in state-sponsored programs.

Kentucky established its plan in 1988 to provide residents with an affordable means of saving for college. Today, 2,602 Kentucky participants have contributed over $5 million toward their childrens' education.

Many Kentuckians are drawn to this program because it offers a low-cost, disciplined approach to savings. In fact, the average monthly contribution in Kentucky is just $49. This proposal rewards those who are serious about their future and are committed over the long-term to the education of their children by exempting all interest earnings from state taxes. It is also important to note that 58 percent of the participants earn under $60,000 per year. Clearly, this benefits middle-class families.

Last year, Congress took the first step in providing tax relief to families investing in these programs. The provisions contained in the Small Business Job Protection Act of 1996 clarified the tax treatment of both the state-sponsored tuition savings plans and the participants' investment. This measure put an end to the tax uncertainty that has hampered the effectiveness of these state-sponsored programs and helped families who are trying to save for their childrens' education.

Already, we can see the result of the tax reforms in the 104th Congress. Last year, Virginia started its plan and was overwhelmed by the positive response. In its first year, the plan sold 16,111 contracts raising $260 million. This response ex-

ceeded the goals set for this program. While we made important gains last year, we need to finish what we have started and fully exempt the investment income from taxation. I am pleased that Sen. Coverdell has included this important provision in S. 1.

Today, I will introduce a stand-alone bill with the support of Senator Graham and others to make the savings in state pre-paid tuition plans exempt from taxation. Although it is similar to the provision in S. 1, it is a more comprehensive proposal that has been developed in close consultation with the states. Like S. 1, it also expands the definition of qualified education expense to include room and board costs. This is important since such costs can amount to 50 percent of total college expenses.

It allows individuals who invested in Savings Bonds to roll them over into the qualified state plan. This is a commonsense provision that will give those who are already saving the flexibility to invest in prepaid plan if available. It also clarifies the law to permit states to establish scholarship programs within the plan. The bill also makes several other minor changes that will help the programs to operate more efficiently, including clarification of the transition rule, permitting the transfer of benefits to cousins and step-children, and permitting states to include proprietary schools as eligible institutions.

This legislation is a serious effort to encourage long-term saving. It is important that we not forget that compound interest cuts both ways. By saving, participants can keep pace with tuition increases while putting a little away at a time. By borrowing, students must bear added interest costs that add thousands to the total cost of tuition.

During the election the President unveiled his education tax proposals. There are two primary provisions to the President's education tax proposal. The first is the HOPE scholarship, which would allow a parent or student to claim a $1,500 non-refundable tax credit for tuition expenses. The other is a $10,000 tax deduction to be applied toward tuition expenses.

The most disturbing aspect of this proposal is its cost. It is my understanding that the President's proposal, if allowed to reach its fullest potential, will exceed $80 billion over the next ten years as estimated by Joint Tax Committee. This contrasts with the modest tax package included in S. 1, which is estimated to cost $18 billion during the same period. This can be compared with the $1.6 million cost associated with the Education Savings Act Senator Graham and I will be introducing later today.

The Administration is quick to point out that their tax package isn't a budget buster because of the tax credit sunset that will be implemented if the President budget isn't in balance by 2002. According the to the CBO the President's budget will run a $69 billion deficit in 2002. With such uncertainty, how does this help families plan for their childrens' future?

The President's proposal has also been criticized because it will also contribute to increased tuition costs. Mr. Chairman, I would ask that an editorial by Lawrence Gladieux, executive director for the College Board and Robert Reischauer, the former director of the CBO, be included with my testimony. Mr. Gladieux and Mr. Reischauer argue that the President's credit would be money in the bank, not only for parents, but the schools as well. This across-the-board tax credit would permit schools to add this subsidy into the cost of tuition. It was also their assumption that the tax benefit would benefit primarily wealthy individuals. This would be two strikes against low-income families who won't benefit from the tax credit, but will still face higher tuition costs.

The authors also point out the President's proposal imposes a new regulatory burden on schools by requiring the IRS to verify that a student received a "B" average in order to be eligible for a second year of this tax credit. Under the President's proposal we will have the IRS grading student papers and publishing tax regulations defining "B" work. It is simply a mistake to use the tax code in this manner.

It is in our best interest as a nation to maintain a quality and affordable education system for everyone. We need to decide on how we will spend our limited federal resources to ensure that both access and quality are maintained. It is unrealistic to assume that the government can afford to provide federal assistance for everyone. However, at a modest cost, we can help families help themselves by rewarding savings. This reduces the cost of education and will not unnecessarily burden future generations with thousands of dollars in loans.

I believe the most prudent approach would be to adopt the tax credits contained in S. 1 and boost need-based grant funding, in particular Pell Grants, that target the low-income families who won't benefit from the President proposal, and might have difficulty saving.

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The following comments focus principally on President Clinton's proposals to provide tax credits and deductions for college tuition to promote access to American higher education. Our own research and our study of the literature persuade us that there are sound reasons to support the President's commitment to expand federal funding for higher education. Economic returns to attending our nation's colleges and universities are at historic highs, and there are few who would dispute the great value of the non-economic returns as well.

At the same time, federal dollars to support students' efforts to get a college education are, and will be, very scarce. It is important to focus support on students who need it most and to provide support in ways that are most likely to achieve the desired effect - encouraging students to attend a suitable college and to do well there.

This is a time of great achievement and great challenge for American higher education. Despite extraordinary real increases in tuition over the past two decades, the percentage of high school graduates attending college is around 60%, an all time high. It isn't difficult to explain why: while in 1980 a student graduating from college could expect to earn about 45% more than a high school graduate, today the differential has almost doubled to 85%. Economic studies place the rate of return to an investment in a college education at more than 10 percent, a figure that compares quite favorably with stocks or bonds. So, even in the narrowest economic terms, higher education is a sound investment. When one adds the important non-economic benefits, the case for allocating more money to postsecondary education is even clearer.

Yet, there are significant challenges facing higher education today. Even as overall college attendance rates have grown, the gap between enrollment rates of students from richer and poorer families has widened. Moreover, for low-income students in many states, the range of institutional types within higher education is becoming increasingly restricted. Our studies of

the college destinations of students from different income backgrounds indicate that rising prices at public universities and four-year colleges, coupled with inadequate student aid for the neediest students, are forcing an increasing percentage of students from low-income families to attend their local community colleges, whether or not that is the best alternative for them in light of their aspirations and capacities. Evidence developed in our work, and by other researchers, shows that subsidies to lower income students are much more effective in stimulating enrollment and expanding educational choice than are subsidies to students from more affluent families.

There is substantial evidence that rising public tuitions coupled with inadequate student aid have produced a crisis of college affordability for many low-income and some middle-income families. Expanded federal investments in higher education are a worthy way to attack this growing problem. If our premise is accepted, the central questions before this Congress are two. First, what is the most effective vehicle for expanding federal higher education investments? Second, which students should be the target of such an expansion?

It is our belief that direct increases in spending on federal grant programs for college students are a more straightforward, transparent, and more easily managed vehicle for expanded federal spending than are new federal tax breaks. An important benefit of grants for people who are struggling to meet college costs is that the funds are available immediately; tax benefits arrive many months after the fact. Nonetheless, we must also recognize that, in the current political climate, tax breaks are more politically saleable than are spending increases that have equivalent impacts on families and on the federal treasury. In this light, we believe that the attractions of a tax cut program for higher education depend critically on the targeting of the benefits. Unfortunately, the most recent incarnation of the President's tax proposals has some serious drawbacks.

As discussed above, low-income families have suffered the greatest reduction in educational opportunity. Yet the Clinton tax credit proposal denies tax

benefits to those who receive $1,500 or more in Pell grants—generally low-income students—while neither the tax deduction nor the credit provide benefits to the lowest income families who do not have enough taxable income to qualify for tax relief. Moreover, the tax deduction the President has proposed will provide greater benefits to persons in higher tax brackets—a result which is hard to justify either in terms of distributive equity or in terms of efficiency in generating higher college enrollments.

President Clinton's proposals could thus be substantially improved by focusing on credits rather than deductions, by allowing students to benefit from both tax credits and Pell grants, by making the credit refundable, by eliminating the B- grade requirement, and by limiting credits for families with higher incomes. Such improved targeting of benefits would make the consequences of this program of tax benefits similar to an expanded Pell grant program—an alternative that is, in our view, more desirable as policy but that may well be politically infeasible.

We are encouraged by the President's proposal to increase the maximum Pell grant from $2,700 to $3,000. But over the past 15 years college tuition has risen by more than 75 percent over and above inflation while the maximum Pell grant has fallen by about a quarter. To restore the real value that the Pell grant had in 1980, we would need a grant of around $4,000. If an increase of this magnitude is out of the question, then an alternative way to get money to those low income students who desperately need it should be considered.

The fact that the President seeks to expand federal funding for higher education is laudable. Economic studies clearly support such an expansion. But we worry that the approach the President has recommended will fall short of achieving its worthy aims. We urge the development of a higher education program that has more direct benefits to the students for whom the issue of college affordability is the most pressing.

April 16, 1997

Treasury Deputy Secretary Lawrence H. Summers
Senate Finance Committee

Mr. Chairman and Members of the Committee:

I am pleased to appear before you today to discuss the higher education tax incentives of the President's Fiscal Year 1998 budget. Providing all Americans with access to higher education is a principal focus of the President's budget. We believe that goal can be achieved as part of the President's comprehensive plan to provide targeted tax relief, promote a fairer tax system, and encourage activities that contribute to economic growth, and balance the budget by Fiscal Year 2002. We are especially pleased that the Committee has chosen to devote this hearing to education issues, and we look forward to working with this Committee to provide increased federal support for higher education.

Secretary Rubin and Secretary Riley have already transmitted to Congress "The Hope and Opportunity for Postsecondary Education Act of 1997" (the "HOPE Act"). The legislation contains the higher education proposals from the President's budget, including the higher education tax incentives. It was introduced in the House as H.R. 1233 by Congressman Clay and Congressman Rangel and in the Senate as S. 559 by Senator Daschle and Senator Kennedy. The proposals contained in the legislation have received support from the American Council on Education as well as presidents or trustees from nearly 400 colleges and universities. We urge you to enact this legislation.

The need for higher education -- both for the individual and for the Nation -- has never been greater. Our economy will prosper in the next century through growing productivity and technological advances only if we have an adaptable and highly-skilled work force. Based on estimates from the Bureau of Labor Statistics, the rise in the average educational attainment of the workforce accounted for one-fifth of the annual growth in productivity between 1963 and 1992.

For individual Americans, higher education produces dramatic results. A college education alone cannot guarantee financial success, but it does increase the likelihood of earning higher

income. In 1979, full-time male workers aged 25 and over with at least a bachelor's degree earned on average 49% more per year than did comparable workers with only a high school degree. By 1993, that difference in wages had grown dramatically, to 89%. Though it has since declined somewhat, the gap remains sizeable. In 1995, the poverty rate was only 3.0% for college graduates (B.A. degree or higher) and 9.6% for high school graduates (with no college education). By increasing opportunities for higher education, we increase the prosperity of our citizens.

The Federal government, through existing student aid programs, has helped to provide educational opportunity for millions of Americans. Nevertheless, students from lower-income families still are far less likely to attend college or earn a degree than are students from higher-income families. Only 23% of high school graduates from families with incomes of $29,000 or less earn a college degree whereas 53% of high school graduates from families with incomes of $78,000 or more graduate from college (using a 1992 study updated to 1997 dollars). Even high school graduates from middle-income families are lagging behind. Only 39% of those from families with income between $29,000 and $78,000 graduate from college. We must do more to encourage students from lower- and middle-income families to pursue their education beyond high school.

To provide support for all of our citizens, young and old, to obtain postsecondary education and training, the Administration proposes to create HOPE Scholarships, permit a tuition deduction for postsecondary education, and create strong incentives for saving to help families pay for postsecondary education costs. The HOPE Scholarships and the tuition deduction, tax cuts worth $36.2 billion between fiscal years 1997 and 2002, are an integrated part of a complete package of measures to support higher education that also includes a $300 increase in the maximum Pell Grant (currently $3000), increased financial assistance to independent students without dependents, and reductions in a variety of student loan fees. Altogether the package provides generous assistance to students from working families who are challenged by the ever increasing cost of college.

We believe that reducing the after-tax cost of education for individuals and families through tax credits and deductions will encourage investment in education and training while lowering tax burdens for middle-income taxpayers. Between 1980 and 1995 real average tuition at public 2-year and public 4-year colleges rose by 75 percent and 92 percent respectively. This jump has far surpassed the growth in median family income which has risen only 4 percent during the same period. Families that are working hard to pay college tuition in the face of this trend deserve relief.

The Administration proposes to provide a large part of that relief through the tax system. Tax incentives provide broad-based assistance without requiring more students to participate in the financial aid system. Tax relief would be provided to families regardless of whether they are saving to send a child to college or paying currently for a member of the family to attend undergraduate or graduate school, yet it is still targeted to the low- and middle-income families that most need the help. Finally, because our economy demands that American workers continue their education throughout their lives, tax benefits are also available for training to acquire or

improve job skills.

Let me now turn to a specific discussion of the higher education tax incentives that the Administration is proposing.

**Higher Education Tax Incentives**

The President's budget contains five specific tax proposals related to higher education. They are:

- **HOPE Scholarship Tax Credit**
- **Tuition Deduction**
- **Extension of Section 127**
- **Small Business Credit for Employer-Provided Educational Assistance**
- **Expanded Tax-Free Loan Forgiveness for Students in Community Service**

*HOPE Scholarship Tax Credits.* Taxpayers would be able to claim a nonrefundable tax credit of up to $1,500 per year (indexed for inflation beginning in 1998) for two years to cover tuition and fees for themselves, their spouses, or their dependents, while enrolled at least half-time in the first two academic years of a degree or certificate program. To take the credit in the second year, the student must have attained the equivalent of at least a B minus grade point average ("B- GPA") in course work completed before that year. No credit would be available if the student has been convicted of a drug-related felony. Federal grants (but not loans or work-study payments) would reduce the allowable credit. The credit would be phased out for families filing a joint return with modified AGI between $80,000 and $100,000 (between $50,000 and $70,000 for single filers), indexed for inflation beginning in 2001. The credit would be available for course work beginning after June, 1997.

*Education and Job Training Tax Deduction.* As an alternative to the HOPE Scholarship, taxpayers could elect to deduct up to $10,000 per year ($5,000 in 1997 and 1998) of tuition and fees for students enrolled at least half-time in a degree or certificate program, or enrolled in courses to improve job skills. The deduction could be claimed even by taxpayers who do not itemize. Unlike the HOPE Scholarship credit, which is calculated per-student, the deduction would not vary with the number of students in a family. The deduction would be phased out at the same income levels as the HOPE Scholarship credit and would be available for course work beginning after June, 1997.

These two provisions will help make 14 years of education the norm for all Americans. They will make a dramatic difference in family finances and are expected to help 12.3 million students in 1998 alone. Some, however, have criticized the B- GPA requirement for the second year of the HOPE Scholarship credit, claiming it will result in grade inflation. We do not believe that will be the case. Teachers face many pressures to give students high grades. For example, in many states students with a certain grade point average pay lower automobile insurance rates.

Similarly, students who participate in athletics or other activities, or who want to go to law school, medical school or graduate school need a high grade point average. We are confident that the sense of integrity and fairness in the classroom that has enabled professors, teachers and instructors to resist the pressure to change their grading practices in response to these other pressures will hold firm in response to any new pressures created by the HOPE Scholarship program. The B- GPA is required because the credit is a form of Federal scholarship. We believe that it is important to use this direct, dollar-for-dollar assistance to encourage students to achieve high academic goals, and that assistance at this level should reward hard work.

Others have criticized our proposals on the grounds that they could lead to inflation in tuition. These arguments do not take account of what we know about institutions of higher education and the market for their services. First of all, there is significant competition among institutions for first-year students that would make it difficult to raise tuition. Second, we have decades of history with federal student aid programs, and there is no credible evidence that existing student aid programs have caused tuition inflation. Third, the HOPE Scholarship is available only for the first two years of postsecondary education, meaning that a tuition increase could have a negative effect on enrollment of third and fourth year students who could benefit from the deduction but not the 100% credit. This problem will also exist to some extent at the two-year institutions because the credit will not be available to second-year students who do not meet the B- GPA requirement and will not be useful to students if they or their families lack sufficient tax liability to make use of it.

***Tax-Free Employer-Provided Educational Assistance.*** Our next proposal would extend the exclusion for employer-provided educational assistance. We should continue to encourage employers to provide educational assistance for their employees. Currently, up to $5,250 of tuition paid by an employer under a qualified educational assistance program need not be included in the income of the employee. However, the exclusion for undergraduate education expires in mid-1997, and the exclusion ceased to apply to graduate-level courses after mid-1996. The Administration strongly believes the tax law should encourage employers to support education for their employees, including those who already have a degree but need to develop new skills. The budget would reinstate the exclusion for graduate-level assistance retroactive to its prior expiration, and would extend both undergraduate- and graduate-level assistance through December 31, 2000.

***Ten Percent Tax Credit to Small Businesses that Provide Educational Assistance to Employees.*** In addition, the Administration believes an additional incentive is appropriate to foster increased educational opportunities and work-force training for employees of small businesses that need extra help to be able to provide education assistance. To provide this incentive, the Administration proposes that for taxable years beginning after December 31, 1997, and before January 1, 2001, small businesses would be allowed a 10 percent income tax credit for payments for education of employees under an employer-provided educational assistance program. A small business would be any employer with average annual gross receipts of $10 million or

less for the prior three years. The proposal would help small businesses reduce the costs of providing educational opportunities for their employees. The extension of section 127 and the small business credit together are expected to benefit 1.7 million taxpayers.

***Expanded Tax-Free Treatment for Forgiveness of Student Loans.*** The Administration believes in encouraging Americans to use their education and training in community service. Providing tax relief in connection with the forgiveness of certain student loans will help make it possible for students with valuable professional skills to accept lower-paying jobs that serve the public. To this end, the Administration proposals would eliminate the tax liability that normally arises when debt is forgiven if the lender is a charitable or educational institution that forgives an education loan after the student fulfills a commitment to perform community or public service at low pay for a certain period of time. The same tax-free treatment would also apply when the Federal government forgives a loan made through the direct student loan program for a student who has been making income-contingent repayments for an extended period.

**Expanded Opportunities to Save for College Tax-Free**

The Administration believes that individuals should be encouraged to save for the costs of higher education, much as they are currently for retirement. It also believes that tax policies can provide valuable incentives to increase saving for education. Therefore, the Administration is proposing to expand Individual Retirement Accounts ("IRAs") and increase their flexibility to help lower and middle-income Americans save for their most important needs. By using an IRA to save for education and combining withdrawals from the IRA with the Administration's proposed tuition deduction, families will be able to save for college on an entirely tax-free basis.

The Administration's proposals would expand the availability of deductible IRAs to families with incomes under $100,000 and individuals with incomes under $70,000.[1] These thresholds, as well as the annual contribution limit of $2,000, would be indexed for inflation beginning in 2001. The President's plan would also create a new Special IRA. Instead of deducting the amount deposited in the IRA account (and paying tax on the contributions and earnings when withdrawn), the taxpayer would forgo an immediate deduction but would not pay tax on either the contributions or earnings when the funds are withdrawn, provided the contributions remain in the Special IRA for at least five years. Finally, the President's proposals would eliminate the penalty for early withdrawal when taxpayers took money out of an IRA for certain key purposes, including paying tuition for postsecondary education (as well as first-time home purchases, paying expenses during extended periods of protracted unemployment and paying certain medical care expenses).

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[1] Beginning in 1997, eligibility would be phased out for couples filing joint returns with AGIs between $70,000 and $90,000 ($45,000 and $65,000 for single filers). Beginning in 2000, eligibility would be phased out for couples filing joint returns with AGIs between $80,000 and $100,000 ($50,000 and $70,000 for single filers).

By using an IRA in combination with the tuition deduction, families would be able to avoid all income tax on college savings. Consider a hypothetical couple who wish to save for their daughter's education. The couple's combined annual income is $60,000. They estimate that by the time their daughter enrolls in college -- approximately twelve years from now -- they will need $10,000 per year for four years to pay her tuition. Under current law, the couple cannot make deductible contributions to an IRA. To save enough to pay their daughter's tuition, they must earn $3,100 each year in order to put away enough money ($2,232 invested at a 7 percent rate of return) to cover her projected tuition costs.

Under the President's proposal, the couple would be able to make a tax deductible contribution to an IRA. Interest earned in their IRA account would accumulate tax free. Then, in 12 years when their daughter goes to college, the couple could withdraw money for her tuition without paying an early withdrawal penalty, and take a tuition deduction to offset the income taxes owed on the IRA withdrawal. If the President's proposal becomes law, the couple could pay their daughter's tuition by contributing only $1,900 of pre-tax earnings per year to an IRA, a savings of $1,200 per year. The President's proposal would make the cost of the daughter's college 39 percent less expensive by allowing completely tax-free saving for college.

The knowledge that savings for college can be tax-free should stimulate many families to plan ahead for college and prepare their children to take advantage of opportunities for higher education. Individuals with moderate incomes and younger people, who are now doing very little saving, should find the greater flexibility of IRAs to meet a wider variety of savings needs, such as first-time home purchases and higher education expenditures, very attractive. They can save on a tax-favored basis for their own or their children's education, knowing that they can use the money for their retirement instead if their children need less than the amount saved. In addition, the knowledge that IRA assets are available to deal with possible family crises, such as protracted unemployment or a serious illness, will make middle-income families more comfortable with beginning a commitment to IRA savings. Moreover, by dramatically increasing the number of middle-income taxpayers eligible for IRAs, the private sector will have an increased incentive to inform the public about the value of tax-preferred savings accounts.

The Administration believes its IRA package will help the middle-income families who are finding it hard to save enough to afford college and discouraging to have their children assume large debts in order to pay tuition.

**Other Higher Education Proposals**

Finally, we are confident that by working together, we can improve access to higher education for all Americans. Last year we worked with Congress to draft and enact legislation that provides favorable federal tax treatment for qualified state tuition programs. Families can use these programs to save for education, and depending upon the terms available in their state, they may be able to guarantee that amounts they pay now will cover tuition at a state school for their children when they are ready to enroll. The state-based programs are providing important new encouragement for educational savings, and we are currently at work on guidance to help states

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implement the standards contained in the law.

Other tax-based proposals to support education have been introduced in this Congress. Although there may be differences on how to target tax relief or structure incentives, we are gratified to see Congress paying so much attention to higher education. As we did with qualified state tuition programs, we can work together to produce legislation that benefits Americans who are trying to use education to make a better future for themselves and their families.

**Conclusion**

In conclusion, the Administration is strongly committed to universal access to higher education. We believe the President's FY 1998 budget plan will accomplish that goal and also reach balance by 2002 with targeted tax reductions that are pro-family, pro-education, and pro-economic growth. We look forward to working with the Committee on these proposals. I would be pleased to answer any questions that you might have.

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**TRACOR**

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Statement of Kathleen Thompson
Vice President, Human Resources, Tracor, Inc.
on behalf of the American Electronics Association and
the Society for Human Resource Management
to the Senate Finance Committee
concerning the employer-provided educational assistance program

April 16, 1997

Members of the committee, my name is Kathleen Thompson. I am Corporate Vice President of Human Resources for Tracor, Inc., a defense electronics company based in Austin, Texas. My office is located in Maryland where I have worked for Tracor for the past 25 years. Tracor is one of three thousand hi-tech members of the American Electronics Association and I personally am a member of the Society for Human Resource Management, who along with its 80,000 members strongly support a permanent extension of Section 127.

Thank you for the opportunity to discuss the reasons why my company, as well as many other employers and all of our employees, would benefit from legislative action making Section 127 (the employer-provided educational assistance program) a permanent part of the tax code and reinstating section 127 retroactively (one last time) back to July 1, 1996 for inclusion of graduate courses.

Tracor, Inc., is, today, the fastest growing defense electronics company in the United States. This is evidenced by the fact that for the past five years Tracor's sales have grown at a compounded annual rate of 43 percent, exceeding $1B in sales in 1996. Although this growth comes from a combination of internal growth and growth through acquisitions, the important fact is not where it came from but how it happened. To quote our CEO and president, Jim Skaggs, from our 1996 Annual Report "...Tracor's successes have been achieved by the growing number of committed and talented employees.....". It is those people I would like to discuss today.

Tracor employs over 10,000 men and women. They work across the United States in 38 states. Tracor's educational assistance program is a staple of our very competitive benefits package and, over many years, hundreds of employees have taken advantage of the program in order to complete a degree. I include myself as one of those beneficiaries of the program and, as such, I am even more strongly committed to employer-provided educational assistance.

Currently Tracor has over 400 employees participating in our tuition assistance program. With the increased cost of a college education today, the average working person simply cannot afford to complete a degree without some financial assistance, and employers have willingly provided that assistance because of the expected return on their investment. I cannot stress enough the struggle that employees and their families have today juggling work and personal life. Our Employee Assistance Program data supports this statement. But when a person makes a commitment to pursue a degree, that struggle intensifies as the time for the coursework is added to the equation. Enormous personal sacrifices must be made to balance it all. Some of those personal sacrifices involve finances, and we know for a fact that some of our employees have curtailed their studies as a result of the on-again, off-again taxing of their reimbursement. Others simply do not understand why they are taxed one time and not another, or worse yet, have to go to the trouble to file an amendment to their tax return in order to recover their tax money when the tax provision is retroactively reinstated.

Currently at Tracor, employees are pursuing mainly technical, engineering and business degrees, at both undergraduate and graduate levels. The high level of engineering/technical participation is very significant to Tracor's ability to acquire the critical skills needed for current and future business requirements. Tracor, along with many other employers today, is experiencing the same difficulty in recruiting and retaining people, particularly those with software development skills. The classified ads in the Washington Post this past Sunday included 15 pages devoted to computer jobs. Tracor is competing in a global economy with unprecedented technological advances. To stay current with these changes, we must provide every opportunity and advantage to our workforce to increase and upgrade their technical expertise in order for the company to remain competitive and profitable. That profitability then translates to Tracor providing even more jobs for the economy.

Tracor encourages and promotes employee self-development through the educational assistance program. We can assume that with increased skill and education, employees will, through their career, whether at Tracor or somewhere else, advance to higher paying positions than they would have without this increased knowledge. This in turn will translate into more tax dollars for the country, certainly far exceeding the dollars "lost" from taxing tuition assistance.

About 28 percent of Tracor's tuition program participants are pursuing graduate degrees. Government RFPs are increasing their requirement for advanced degrees and Tracor simply cannot compete without them. We do not want to see certain employees suffer a tax liability depending on the level of education they pursue, especially if we are strongly encouraging them to do so. We believe that both undergraduate and graduate educational assistance must receive equal tax treatment. Currently, we experience an added administrative step as we process tuition reimbursements and have to determine, depending on degree pursued, whether it goes to payroll or accounting for payment.

Since its first enactment as part of the Revenue Act of 1978, section 127 has been reinstated, retroactively, a total of eight times. This on-again, off-again extension has created innumerable administrative burdens for employers, not to mention the confusion for employees who must deal with unanticipated tax liabilities. For example, the last reinstatement was enacted retroactive to the previous tax year. Consequently, Tracor had to prepare corrected W-2 forms and corrected multiple state and federal tax reports as well as refund FICA tax. Then there were those employees who had already filed their taxes at that time who had to file an amended return in order to recover their money. Previous years' retroactivity required notices to affected employees and issuance of checks for the taxes withheld. Needless to say, no employer needs or wants this bureaucratic burden, especially government contractors who are audited on a regular basis and who are constantly streamlining processes in order to remain competitive.

In closing, thank you to Chairman Roth and ranking member Senator Moynihan for your hard work in introducing S.127, the leading legislative proposal for permanent extension of Section 127 and thank you to the rest of the Committee for your support. I am available at this time to answer any questions the Committee might have.

# COMMUNICATIONS

## STATEMENT OF THE COLLEGE BOARD

[SUBMITTED BY LAWRENCE E. GLADIEUX, EXECUTIVE DIRECTOR FOR POLICY ANALYSIS]

My name is Lawrence Gladieux. I am executive director for policy analysis of the College Board, a national association of 3,000 schools and colleges dedicated to advancing equity and excellence for all students. Along with promoting high standards for all, the College Board since the 1950s has been a leader in developing the principles and practice of need-based student financial assistance aimed at equalizing access to postsecondary education.

Thank you for the opportunity to submit views on pending education tax plans, especially the Administration's proposals for tuition tax credits and deductions.

Two attached documents place my testimony in context:

- The first is a resolution issued by the Trustees of the College Board that "commends the Clinton Administration for its substantial support of education; reaffirms the College Board's historic commitment to need-based student financial aid; and urges that proposals for tuition tax credits or deductions not be allowed to substitute or reduce funding for need-based aid." The resolution expresses concern that, with pressures to balance the federal budget, the government will not be able to "afford the estimated revenue loss from the tuition tax proposals while maintaining--let alone expanding--current appropriation levels for need-based student aid programs." Consistent with the Trustee resolution, a recent survey of College Board member institutions indicated strong support for restoring the value of Pell Grants and other increases in need-based student aid; they also support tax incentives, but not at the expense of need-based aid.

- The second is an op-ed piece that I co-authored last fall with Robert Reischauer, former director of the Congressional Budget Office. From the standpoint of both tax and education policy, we questioned the wisdom of investing $40 billion in scarce federal resources in the tuition credit/deduction plan.

As both the resolution and the op-ed piece began, I want to begin my statement: The priority that this Administration has assigned to education is unprecedented and the College Board applauds it. We are fortunate to have an education president who has argued consistently and passionately that the country needs to invest more in education and training to boost economic growth, expand opportunity, and reduce growing income disparities.

But the President's proposed tax breaks for college tuition would not be an effective way to achieve these worthy objectives. By and large they would benefit students and families in the upper income quartiles, where college enrollment rates are already very high and have been rising. Nine out of ten 18-24 year-olds from households in the top income quartile enroll in some form of postsecondary education or training, compared to a ratio of one out of two from the lowest income quartile. The plan may be one way to cut taxes, but it is not an effective strategy for lifting the country's net investment in education or closing gaps in opportunity. Most of the relief would go to students and families who are likely to find the resources and attend higher education regardless.

College tuition levels have been rising faster than inflation for the past 15 years, so the burden of paying for higher education has increased for most families. But with widening income disparities in the 1980s and 1990s, it has increased the most for those on the bottom rungs of the economic ladder. College costs are taking a larger and larger bite out of low and moderate family incomes.

The proposed tax breaks will not help those most in need. Since the current version of the tax credit is non-refundable (in an earlier version it would have been refundable), students and families with no or minimal tax liability could not benefit. And under the Administration's plan, eligibility for the tax credit would be offset dollar-for-dollar by the amount of federal grant aid received by the student. This offset provision would effectively exclude more than 3.5 million students below the median family income (almost $40,000 in 1995) who receive Pell Grants.

As part of its overall package for making college affordable, the Administration has proposed a much-needed $300 increase in the maximum Pell Grant, but this does not balance the scales compared to a $1,500 tax credit or a $10,000 deduction, and it only begins to restore the purchasing power of Pell Grants that has been lost in past two decades. Since 1979, the value of the maximum Pell has steadily dwindled relative to the cost of higher education, in 1995 covering less than 40 per cent of the average cost of attendance at a four-year public institution and only 15 percent of the average cost at a four-year private institution.

In addition to the offset for federal grants, tuition and fees as counted in the formulas would be reduced by the amount of *non-federal* grant aid. This would exclude or limit eligibility for the tax breaks in the case of many moderate- to middle-income students who receive various non-federal grant and scholarship assistance. State, institutional, and private grant programs extend assistance to students in the $30-60,000 range or higher. Thus many middle-income students who are the intended target of the Administration's proposal will not benefit.

Even if the tax credit were to be made refundable, thus extending the benefit to some lower-income students, the timing of such a tax benefit reduces its practical value to families trying to make ends meet. A tuition bill paid in the fall might result in a year-end tax refund four or six months later; a second-semester tuition payment in January might produce tax relief 12-14 months later. Some taxpayers might plan ahead and adjust their payroll withholding, but most won't, and many can't afford to. The tax code, I suggest, is not an effective vehicle for helping people who are struggling to meet current tuition expenditures.

I also worry, as do many others in the higher education community, about unintended consequences of the President's proposal, including regulatory entanglement with the Internal Revenue Service. Involving the IRS in the delivery of such educational benefits, I believe, would be a mistake (IRS has consistently argued against such proposals through several administrations). It is not just the B-average and drug-free requirements (which are eligibility conditions for receipt of the tax credit though not the deduction). Colleges would more than likely be implicated in verifying tuition payments as well as receipt of federal and non-federal grant assistance which offset the tax benefits. In the end, I believe it would add multiple layers

of complexity not only to the tax code but to the overall financing of students in higher education.

My overriding concern about the President's plan, however, comes down to issues of fundamental fairness, equity, and access. If the tuition tax breaks were to be enacted on anything like the scale proposed in the Administration's 1998 budget, they would establish by way of the tax code a major new entitlement for the middle- and especially upper-middle classes, with the potential of shifting federal resources over time away from the neediest students and families.

The focus of federal higher education policy has long been to promote and equalize access, especially for those with the fewest resources, and this fundamental commitment should not be eroded. We applaud the Administration's proposed increase for Pell Grants--and the College Board will support it vigorously. But the overall package remains imbalanced.

If the country really can afford something approaching $30-40 billion in additional resources to expand access to higher education over the next five years, surely it would be better invested in Pell and other grant, loan, and work-study programs. They help low- and, yes, middle-income students based on need, and they get the dollars to students when tuition bills are due, not months later in a tax refund.

**Who Specifically Would Benefit from the Proposed Tuition Tax Relief?**

So far, the debate on the President's proposals has proceeded largely without data-based projections of the potential distribution of benefits. The Administration has said that the plan would broadly benefit middle-income Americans. I and others have suggested that the biggest benefits would go to the upper-middle class. In or out of the Administration, there is little analysis to inform the debate.

In the education community, we are hampered by the difficulty of assembling all the data (and tax modeling expertise) required to produce estimates of our own. The eligibility formulas are complicated. I am attaching descriptions and examples of the formulas for the proposed tax credit (up to $1,500) and deduction (up to $10,000). The taxpayer could choose between the two for the first two years of postsecondary education, after which the deduction alone would be available. To project the potential benefits, data or proxy data have to be assembled on at least the following: income distribution of students and dependency status; enrollment distribution by year in college and part-time/full-time status; tax filer information; tuition and fees paid by students/parents; and grants received, federal and non-federal. Many of the variables are interactive, complicating the modeling and analysis.

Last week the Administration released "illustrative examples" of who would receive the tax benefits among students at several different income levels if they attend an average-cost community college, four-year public institution, or four-year private institution. The attached Figure 1 illustrates the Administration's estimates of benefits for dependent students in the first or second year of postsecondary education. By far the largest benefits--the full value of the

$1,500 tax credit--go to the student with a $60,000 family income, while the benefit is half that for students at the $20,000 and $30,000 income levels if they attend a four-year private college and negligible if they attend a public or community college. If the Administration were to release estimates for income levels higher than $60,000, I believe the data would show much larger benefits as the full value of the $10,000 tax deduction comes into play.

I should underscore that these projected benefits are for dependent students, those who are deemed to rely primarily on their parents or guardians for financial support. The Administration's estimates for independent students (now a majority of the postsecondary student population) show that the maximum tax credit of $1,500 would be received by students at the $20,000 and $30,000 levels, whichever type of institution they attend. The fact is, however, that one-third of independent students attending four-year institutions and one-fifth attending two-year public institutions have less than $10,000 in annual income, where the Administration's estimate shows zero benefits. Most of these students simply do not have sufficient income and thus tax liability to take advantage of the proposed credit.

Again, the Administration has not released estimates for higher-income levels, where the benefits are likely to be the greatest, especially for dependent students attending relatively high-tuition colleges and receiving the benefit of the tax deduction. To illustrate, Figure 2 projects the average tax benefits by family income at a private four-year college charging tuition of more than $20,000. The greatest average tax benefit; more than $2700, would be received by families in the $70,000-80,000 range. As the bar graph illustrates, even in the $80,000-100,000, income range where eligibility is phased out under the administration proposal, the benefits would still be greater than they would in the $50,000 range and below.

I have mentioned the inter-activity of the variables in the formula. Even when more definitive estimates can be developed, the fact is that such new tax benefits will interact with financial aid policies at the campus (and possibly state) level in ways that no model can predict. For example, institutions that award substantial amounts of need-based aid from their own funds are likely to take the tax benefits into account, either prospectively or retrospectively, when they evaluate family ability to pay. Thus many students and families that might receive the proposed tuition tax relief could see the benefit offset by reduced eligibility for campus-awarded student aid.

**Alternative, Focused Uses of the Tax Code**

Having summarized my concerns about the Administration's proposals, I do support judicious use of the tax code to help students and families finance the costs of postsecondary education. The College Board Trustee resolution recommends alternatives that would "boost college attendance, encourage families to save for college, and help relieve student debt burdens." Accordingly, I urge the committee to consider selective tax provisions focusing on the front and back ends of the college financing continuum:

- ***College Savings.*** We need to encourage more middle-income families to save for their children's education. Currently, within certain income limits, the tax code excludes from

income the interest earned on Series EE Savings bonds if the bonds are used to pay for higher education. Pending proposals, including the President's plan and Republican bills, call for additional incentives for the same purpose, either through expanded use of IRAs or new investment accounts dedicated to postsecondary financing. Increased incentives for savings would be helpful.

- ***Student debt burden relief.*** A measure of tax relief for student borrowers in repayment would also be constructive. Debt burdens are rising precipitously fo. many students. Both S. 1 and S. 12, the Republican and Democratic leadership proposals, respectively, call for "above the line" deductibility of interest on student loans, with benefits phased out at higher income levels.

I also urge the committee to vote permanent extension of Section 127 exempting employer-provided tuition benefits, for both graduate and undergraduate training, from an employee's gross income. This has been an on-again, off-again provision in the tax code. Section 127 is a modest incentive for private sector investment in continuing education of adults. It supports lifelong learning. Studies show that beneficiaries earn close to the national average for full-time, year-round employees.

Modest, focused adjustments to the tax code along these lines would not be an expensive drain on the Treasury or add great new complexity to the tax system. And they would complement, not compete with, existing need-based aid programs.

**Tuition Tax Relief and Student Aid**

Last month I delivered testimony much like this statement to both the House Ways and Means Committee and the House Committee on Education and the Workforce. The latter committee has jurisdiction over the student financial aid programs under Title IV of the Higher Education Act (HEA), which is scheduled for reauthorization during the 105th Congress. I told the committee that the higher education reauthorization seems destined to be the caboose on this debate over the federal role in financing postsecondary education that has been sparked by the President's tuition tax proposals. Until Congress has decided the extent and nature of tuition assistance that may be incorporated in the tax code, the education authorizing committees will not have all the information they need to proceed with reauthorization. New benefits provided through the tax code--who benefits and how--will surely need to be taken into account as Congress considers changes to the aid programs under the HEA.

The Administration has said that it intends to hold harmless the student financial aid that beneficiaries of the proposed tuition breaks might otherwise receive. In other words, the Administration says the tuition tax relief given with one hand should not be taken away by the other. In fact, as I have suggested above, colleges (and states) may decide to change their policies for awarding *non-federal* student assistance in light of any federal tuition tax benefits, and I doubt that the federal government's influence over such ripple effects in non-federal aid

eligibility could extend beyond jawboning. Campuses have the right to award their own funds as they see fit.

Under the so-called Federal Methodology for determining eligibility for Title IV aid, however, students and their families receiving the proposed tuition tax deduction (should it be enacted) would actually show less taxable income, thus *greater* "need" for federal aid. On the other side of the balance sheet, taxpayers receiving either a tuition tax credit or deduction would show less U.S. taxes paid under the Federal Methodology, thus potentially reducing their eligibility for Title IV aid. It's premature to speculate any further at this stage on such scenarios of interaction with federal student aid eligibility. Suffice it to say that the Administration will have to seek at least some technical changes in the HEA in order to achieve its "hold harmless" objective for tuition tax beneficiaries.

I want to submit one last observation on the issue of "who benefits." The Administration has said that its tuition tax proposals are intended to pick up where current student aid benefits leave off, implying that the tax proposals are for the middle class while financial aid only reaches the poor. There is a misconception here. In fact, the attached Figure 3 indicates that average federal student aid awards are greater for middle- and upper-income families than for low- and moderate-income families, and this pattern has become more pronounced in recent years. More of the aid going to middle- and upper-income families is in the form of loans than is the case in the lower-income ranges. But my point is that existing student aid is not just for the poor, far from it. The benefits extend much further up the income scale. I believe it is important to keep this in mind as debate continues, on the tax proposals that are before this committee and on the reauthorization of the Higher Education Act that is pending in the Committee on Labor and Human Resources.

Thank you for the opportunity to address these important issues of tax policy and financing higher education.

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Washington Office

# Tuition Tax Proposals and Student Aid

Board of Trustees of the College Board
January 26, 1997

Whereas in March 1996 the Board of Trustees adopted a resolution (see attached) that urged the Congress and Administration to maximize support for need-based student assistance--especially grants, with the objective of increasing aid to the neediest students;

Whereas the Clinton administration has given high priority to education and has proposed to extend opportunity to all Americans for at least two years of postsecondary education through tax credits for tuition payments, and lessen the financial burden of postsecondary education for many families through itemized tax deductions for tuition payments;

Whereas the Administration and Congress have both endorsed a balanced budget by 2002, thus making it improbable that the government can afford the estimated revenue loss from the tuition tax proposals while maintaining--let alone expanding--current appropriation levels for need-based student aid programs;

Therefore, be it resolved that the Board of Trustees of the College Board:

- commends the Clinton administration for its substantial support of education;
- reaffirms the College Board's historic commitment to need-based student financial aid; and
- urges that proposals for tuition tax credits or deductions not be allowed to substitute or reduce support for need-based aid.

Further, the Board of Trustees calls upon the College Board staff to:

- analyze and disseminate information on the potential distribution of benefits of tuition tax proposals;
- explore and advance changes to the tax code that would bolster college attendance, encourage families to save for college (e.g., education IRAs), and help relieve student debt burdens (e.g., restoration of student loan interest deductibility); and
- also support increased appropriations for Pell Grants and other need-based aid to restore the purchasing power that these programs have lost over the past fifteen years.

Board of Trustees - March 28-29, 1996

**Support for Need-Based Student Aid**

**Whereas** the College Board champions educational excellence for all students through the ongoing collaboration of member schools, colleges, universities, educational systems, and organizations; and;

**Whereas** the Board of Trustees has established an equity agenda for the College Board with the goal that, by the end of the twentieth century, individuals from traditionally underrepresented groups have access to and complete postsecondary education at the same rate as traditional students; and

**Whereas** wide disparities in educational attainment persist in the US, and a young person from a family in the top income quartile is ten times more likely to have received a college degree by age 24 than another person whose family income falls in the bottom quartile; and

**Whereas** need-based financial assistance is critical as a factor in equalizing college opportunities and in providing an incentive for low-income families to prepare for postsecondary education; and

**Whereas** there is evidence that grant aid is more effective than loan assistance in boosting participation rates as well as helping low-income students stay in college and complete their degrees; and

**Whereas** today most federal aid is in the form of loans (75 percent) rather than grants (25 percent), compared to the reverse 20 years ago (75 percent grants, 25 percent loans); and

**Whereas** proposals for academic merit-based federal scholarships should not be allowed to substitute or reduce support for need-based student financial aid; and

**Whereas** need-based postsecondary financial aid is a vital investment in the our future economic security and competitiveness;

**Therefore be it resolved:**

That the College Board urge Congress and the Administration to maximize support for need-based student assistance, especially grant aid, throughout the FY 1997 federal budget deliberations, in the 1997-1998 reauthorization of the Higher Education Act, and beyond, with the objective of increasing the amount of aid available to the neediest students.

# The College Board

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*Lawrence E. Gladieux*
*And Robert D. Reischauer*

# Higher Tuition, More Grade Inflation

*Tuition tax breaks would be bad fiscally and worse educationally.*

More than any president since Lyndon Johnson, Bill Clinton has linked his presidency to strengthening and broadening American education. He has argued persuasively that the nation needs to increase its investment in education to spur economic growth, expand opportunity and reduce growing income disparities. He has certainly earned the right to try to make education work for him as an issue in his reelection campaign, and that's clearly what he plans to do.

Unfortunately, one way the president has chosen to pursue his goals for education is by competing with the GOP on tax cuts. The centerpiece of his education agenda—tax breaks for families paying college tuition—would be bad tax policy and worse education policy. While tuition tax relief may be wildly popular with voters and leave Republicans speechless, it won't achieve the president's worthy objectives for education, won't help those most in need and will create more problems than it solves.

Under the president's plan, families could choose to deduct up to $10,000 in tuition from their taxable income or take a tax credit (a direct offset against federal income tax) of $1,500 for the first year of undergraduate education or training. The credit would be available for a second year if the student maintains a B average.

The vast majority of taxpayers who incur tuition expenses—joint filers with incomes up to $100,000 and single filers up to $70,000—would be eligible for these tax breaks. But before the nation invests the $43 billion that the administration says this plan will cost over the next six years, the public should demand that policy makers answer these questions:

- **Will tuition tax credits and deductions boost postsecondary enrollment?** Not significantly. Most of the benefits would go to families of students who would have attended college anyway. For them, it will be a windfall. That won't lift the country's net investment in education or widen opportunities for higher education. For families who don't have quite enough to send their child to college, the tax relief may come too late to make a difference. While those families could adjust their payroll withholding, most won't. Thus any relief would be realized in year-end tax refunds, long after families needed the money to pay the tuition.
- **Will they help moderate- and low-income students who have the most difficulty meeting tuition costs?** A tax deduction would be of no use to those without taxable income. On the other hand, the proposed $1,500 tax credit—because it would be "refundable"—would benefit even students and families that owe no taxes. But nearly 4 million low-income students would largely be excluded from the tax credit because they receive Pell Grants which, under the Clinton plan, would be subtracted from their tax-credit eligibility.
- **Will the plan lead to greater federal intrusion into higher education?** The Internal Revenue Service would have to certify the amount of tuition students actually paid, the size of their Pell Grants and whether they maintained B averages. This could impose complex regulatory burdens on universities and further complicate the tax code. It's no wonder the Treasury Department has long resisted proposals for tuition tax breaks.
- **Will the program encourage still higher tuition levels and more grade inflation?** While the tuition spiral may be moderating slightly, college price increases have averaged more than twice the rate of inflation during the 1990s. With the vast majority of students receiving tax relief, colleges might have less incentive to hold down their tuition increases. Grades, which have been rising almost as rapidly as tuition, might get an extra boost too if professors hesitate to deny their students the B needed to renew the tax credit.
- **If more than $40 billion in new resources really can be found to expand access to higher education, is this the best way to invest it?** A far better alternative to tuition tax schemes is need-based student financial aid. The existing aid programs, imperfect as they may be, are a much more effective way to equalize educational opportunity and increase enrollment rates. More than $40 billion could go a long way toward restoring the purchasing power of Pell Grants and other proven programs, whose benefits inflation has eroded by as much as 50 percent during the past 15 years. Unlike tuition tax cuts, expanded need-based aid would not drag the IRS into the process of delivering educational benefits. Need-based aid also is less likely to increase inflationary pressure on college prices, because such aid goes to only a portion of the college-going population.

Economists have long argued that the tax code shouldn't be used if the same objective can be met through a direct-expenditure program. Tax incentives for college savings might make sense; parents seem to need more encouragement to put money away for their children's education. But tax relief for current tuition expenditures fails the test.

Maybe Clinton's tuition tax-relief plan, like the Republican across-the-board tax-cut proposals, can be chalked up to election-year pandering that will be forgotten after November. But oft-repeated campaign themes sometimes make it into the policy stream. That was the case in 1992, when candidate Clinton promised student-loan reform and community service that, as president, he turned into constructive initiatives. If reelected, Clinton again may stick with his campaign mantra. This time, it's tuition tax breaks. This time, he shouldn't.

*Lawrence E. Gladieux is executive director for policy analysis of the College Board. Robert D. Reischauer is senior fellow in economic studies at the Brookings Institution and former director of the Congressional Budget Office.*

**The Washington Post**
**Wednesday, September 4, 1996**

## Formula for Calculating the "Hope Scholarship" Tax Credit

$$\text{CREDIT} = \left( \text{The Lesser of } \begin{matrix} \text{Tuition + Fees} - \text{Non-Federal Grants} \\ \text{- or -} \\ \$1{,}500 \end{matrix} \right) - \text{Federal Grants}$$

***Example A***
Tuition + Fees = $2,000
Non-Federal Grants = $1,000
Federal Grants = $750

**Step 1:** Subtract non-federal grants from tuition and fees:
**(2,000 – 1,000) = 1,000**

Because this amount is less than $1,500, it is used in the calculation.

**Step 2:** Subtract federal grant total from previous sum:
**1,000 – 750 = 250**

*The taxpayer would be entitled to a $250 tax credit.*

***Example B***
Tuition + Fees = $5,500
Non-Federal Grants = $1,000
Federal Grants = $750

**Step 1:** Subtract non-federal grants from tuition and fees:
**(5,500 – 1,000) = 4,500**

Because this amount is more than $1,500, the maximum credit of $1,500 must be used in the calculation.

**Step 2:** Subtract federal grant total from previous sum:
**1,500 – 750 = 750**

*The taxpayer would be entitled to a $750 tax credit.*


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## Formula for Calculating the Clinton Tuition Tax Deduction

**DEDUCTION = (Tuition + Fees – All Grants) OR $10,000** ***(whichever is lower)***

***Example A***
Tuition + Fees = $7,500
Non-Federal Grants = $1,000
Federal Grants = $750

**Calculation:** Subtract the total grant amount from tuition and fees:
**(7,500 – (1,000 + 750)) = $5,750**

*Because the total is lower than the $10,000 maximum deduction, the taxpayer would be entitled to a deduction of $5,750.*

***Example B***
Tuition + Fees = $18,000
Non-Federal Grants = $3,000
Federal Grants = $0

**Calculation:** Subtract the total grant amount from tuition and fees:
**(18,000 – (3,000) = $15,000**

*Because the total is larger than the deduction limit, the taxpayer would be entitled to a maximum deduction of $10,000.*


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**Figure 1. Projected Average Tax Benefit for First and Second Year Dependent Students Based on the Administration's Proposal, by Institution Type and Selected Family Income Levels (Data Source: U.S. Department of Education, February 1997)**

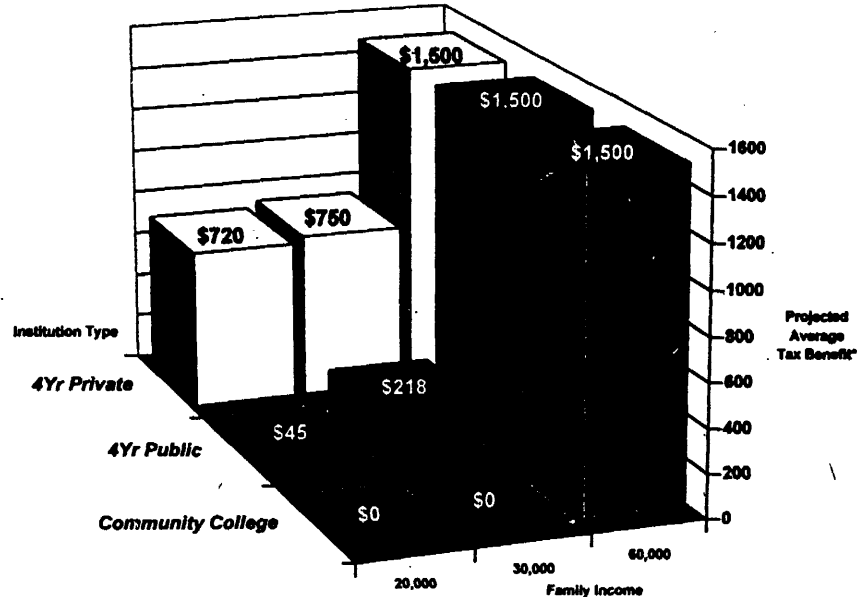

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**Figure 2. Projected Average Tax Benefit for an Incoming Dependent Freshman student at an Independent Private Four-Year College Based on the Administration's Proposal, by Family Income****

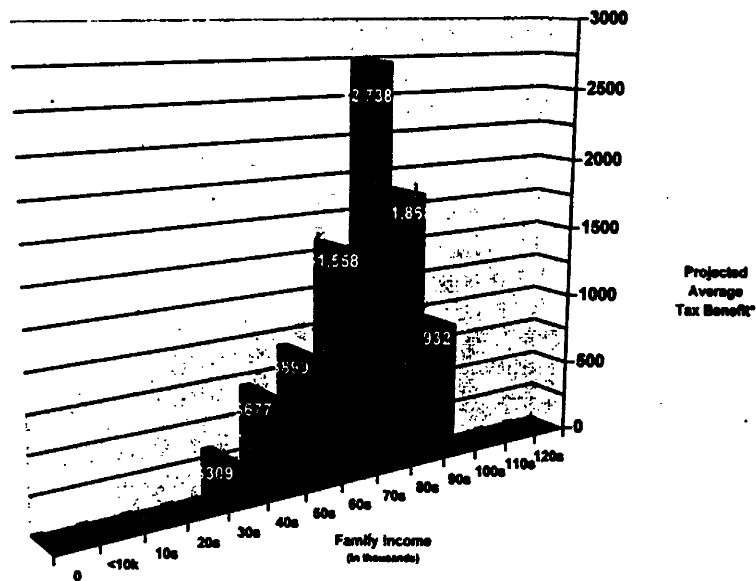
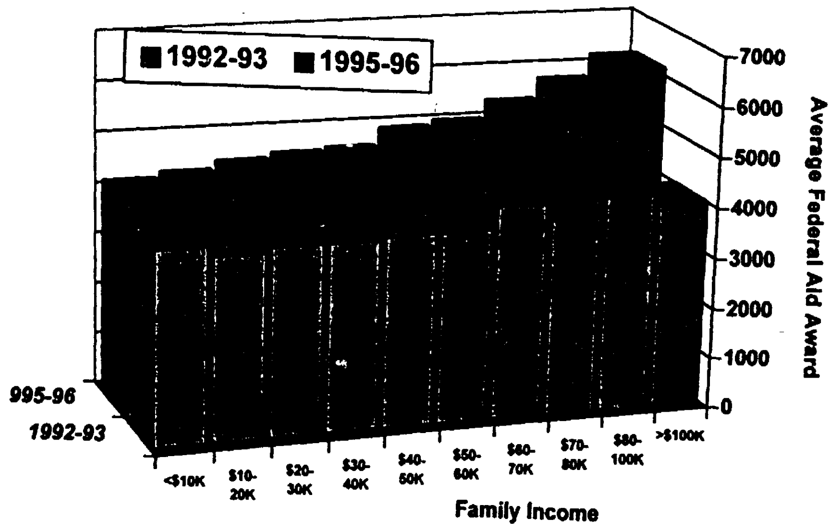


**Figure 3. Middle- and Upper-Income Families are Getting More Federal Student Aid.** *(Source: U.S. Department of Education, NPSAS, 1993 and 1996)*



Peter A. Roberts
Chairman and Chief Executive Officer
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5 Vaughn Drive
Princeton, N.J. 08540

My comments are directed to S.1, the Safe and Affordable Schools Act of 1997, and S.594, the College Savings Act of 1997. In particular, Section 301 of S.1, the Bob Dole Education Investment Account (BDEIA), has to be modified to create a level playing field between all market participants in the college savings marketplace. Such a modification is necessary to help improve the family savings rate.

Briefly, I am the founder, chairman, and chief executive officer of College Savings Bank, a New Jersey-chartered, FDIC-insured savings bank located in Princeton.

College Savings Bank in 1987 was formed for the primary purpose of originating and marketing the patented CollegeSure® Certificate of Deposit, America's first commercially available and nationally marketed college cost prepayment product.

I am also the inventor of the CollegeSure CD.

## WITHOUT REVISION, S.1 AND S.594 WILL TEND TO SOCIALIZE MARKET

One solution to increasing the rate at which families save for college is to provide tax incentives. However, the tax incentives have to be carefully designed so as to permit college savers sufficient investment flexibility and encourage the participation of the private sector.

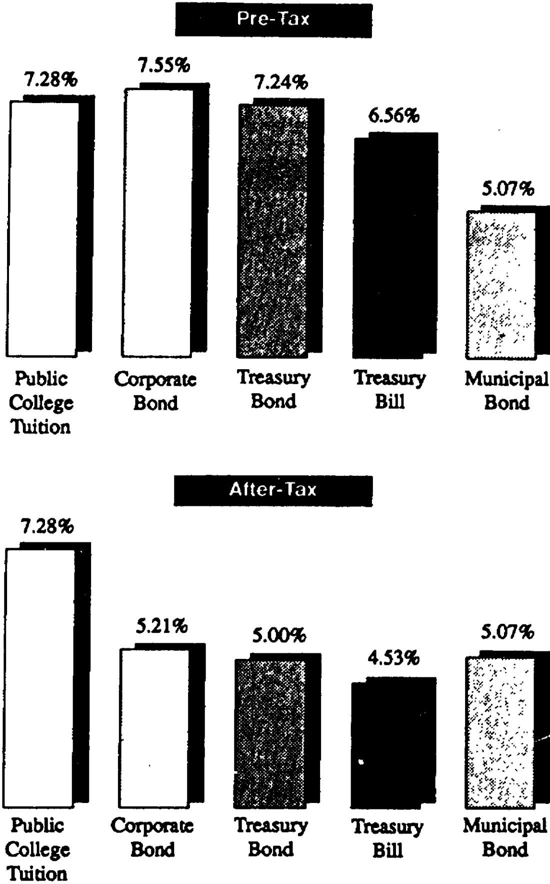
Legislation recently has been introduced which would make state college savings programs exempt from federal taxes. S.594 and Section 303 of S.1 would exclude from gross income any amounts distributed from qualified state tuition programs and used to pay for qualified higher education expenses. Neither bill provides comparable benefits for college savings through the private sector.

In the short-run, either bill would increase the flow of funds to state-sponsored college savings programs and may increase college-targeted savings. However, legislation that provides substantial tax benefits only to state-sponsored savings programs may have adverse long-term consequences.

The proposed legislation would convert taxable state investment contracts into tax-exem[illegible] [illegible]ligations with yields matching the pre-tax yields of U.S. Treasury and corporate obligations (See Figures).

# FIGURES

**Average Annual College Inflation Rate Versus Rates of Return on Selected Corporate, U.S. Treasury and Municipal Securities, 1965-1996**




NOTES: The after-tax graph assumes a 31% marginal income tax rate.

College inflation is measured as the annual rate of change in tuition and required fees (in-state) for all public higher education institutions in the United States as reported in "Digest of Education Statistics," U.S. Department of Education, Washington, D.C. (1996).

Average annual rates of return on corporate bonds, U.S. Treasury bonds and U.S. Treasury bills were calculated from total annual returns reported in "Stocks, Bonds, Bills and Inflation, 1997 Yearbook," Ibbotson Associates, Inc. Chicago (1997).

Average annual rate of return on municipal bonds was calculated in the same manner as Ibbotson Associates computed annual corporate and Treasury returns based on monthly yield data for 10-year, prime grade, general obligation municipal bonds reported in "Analytical Record of Yields and Yield Spreads," Salomon Brothers Inc., New York, September 1990 and monthly updates through 1996.

Unless similar benefits are provided for savings products offered by the private sector, either bill, if enacted, would create pre-emptive state savings products that would crowd out virtually all private sector competition in the marketplace. Investor choices will be distorted and college savers will divert the portion of a family's total savings earmarked for college away from other savings vehicles and into the state savings plans.

The effect of tax exemption on state savings plans is very different than the effect of tax exemption on municipal bonds. Whereas the market adjusts the yields on municipal bonds to be lower than the yields on taxable bonds, the yields on the obligations issued by state savings plans are reflective of the yields on the taxable investments in the trust and, because the obligations issued by the trust are non-negotiable, not able to seek equilibrium to the yields on other tax-exempt instruments. The tax-exempt feature creates a superordinary after-tax yield which preempts all comparable investments in the marketplace. It has the effect of flooding the market with subsidized, above-market rate and below-market priced instruments. In international banking parlance, it's called 'rate dumping.'

The disintermediation and market-damaging effects caused by a preemptive savings product will discourage those entities that now seek to help savers and reduce the range and variety of investment choices. It will increase the size of state governments, crowd out the private sector, socialize the market, and in the long-run reduce the rate at which families save for college.

## LET'S INCREASE THE COLLEGE SAVINGS RATE THROUGH MARKET-BASED SOLUTIONS

Congress can avoid the pre-emptive effects of S.1 and S.594 if it expands the legislation to extend the tax benefits provided to qualified state tuition programs to all college savings. This would:

- Provide college savers with a wide range of investment choices;
- Maintain a level playing field;
- Reach a broad spectrum of eligible families; and
- Create a competitive, healthy and innovative marketplace that is necessary to maximize the national savings rate.

**REVISIONS TO FEDERAL LEGISLATION**

The best way to maximize the effectiveness of tax benefits offered to college savers would be to (1) extend tax exemption to all savings placed in a Bob Dole Education Investment Account (BDEIA) proposed in Section 301 of S.1 and (2) clarify Section 303 of S.1 and S.594 to ensure that state college savings programs based on public/private partnerships have the flexibility to operate efficiently.

First, the BDEIA's contribution limits should be modified to mirror the limits contained in IRC § 529(b)(7). The proposed $1,000 annual contribution limit pales in comparison to the limits for qualified state tuition programs which permit contributions "necessary to provide the qualified higher education expenses of the beneficiary." Such qualified contributions theoretically include amounts sufficient to fund four years of college and four years of medical school at an Ivy League institution per child (i.e. greater than $100,000).

Senator John Warner (R-VA), speaking about the Virginia Prepaid Education Program on the Senate floor on April 16, 1997, asserted, "During the first 3-month enrollment period, over 16,000 children were enrolled in VPEP. The value of these contracts total over $260 million..." This means that in one quarterly period, Virginia sold contracts with an average value of $16,250 per child. Obviously, the private sector could not compete with annual contributions limited to $1,000 per child for the BDEIA.

The BDEIA (with modified contribution limits) would help level the playing field for all market participants and avoids the market damaging effects that may be caused by a preemptive government savings product.

Second, numerous states have developed or are in the process of developing college savings programs that do not use state-operated trusts. These programs reduce the potential actual or equitable liabilities of the state if a program is underfunded or actuarilly unsound. Such states have entered or intend to enter into contracts with one or more financial institutions pursuant to which college savers (or a state agency as trustee) would purchase instruments offered by the institution. These programs give college savers investment choices which will help maximize the family savings rate. Examples of such state programs are the Arizona Family College Savings Program, the Montana Family Education Savings Program, the Indiana Family College Savings Program, and the Illinois College Accounts Network.

These programs are developing slowly because there is some question as to whether Section 529(b)(5), which limits investment direction by the saver, prevents college savers from making initial choices as to how their savings will be invested.* Congress should eliminate this ambiguity by inserting at the end of Section 529(b)(5) language similar to the following:

> *"This prohibition on investment direction will not be violated merely because a program permits a contributor to choose among investments when a contribution is made, a designated beneficiary is changed, or there is a significant unanticipated change in the program, such as the termination of the investment option that the contributor previously selected."*

If a grandmother living in one state can choose to place college savings for her grandchild in a prepaid tuition program sponsored by her state of residence, a state-managed savings trust managed by the state in which her grandchild resides, or in a prepaid tuition program sponsored by another state, there is no reason why a state should not be able to offer several different college savings options. Obviously, this raises the question why are there investment direction restrictions on college savings plans when there are no similar restrictions on tax-favored retirement plans?

In sum, the modified BDEIA and clarified qualified state tuition program are market-based solutions. They help provide college savers with a wide range of investment choices, reach a broad spectrum of eligible families, and create a competitive and innovative marketplace necessary to maximize the college savings rate. Without increasing the size of government, BDEIAs and public/private partnership-based state programs tap the abundant resources of the private sector to cultivate thrift among families with college bound children and improve the rate at which families save.

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* States that are adopting these programs have assumed that they will be treated as "established and maintained" by the State as required by Section 529. However, to avoid any ambiguity, we would like to see language in Section 529 stating:

> *"A program will not fail to be considered 'established and maintained' by a State or agency or instrumentality thereof solely because contributions are directly or indirectly placed in instruments or funds managed by private persons rather than being placed into a fund or trust over which the State or agency or instrumentality has investment control."*

**Statement of the Section 127 Coalition
on
Education Tax Proposals**

**Committee on Finance
United States Senate**

**April 16, 1997**

The Section 127 Coalition is a diverse group of business, labor, professional and education organizations that are committed to making the exclusion for employer-provided educational assistance found in section 127 a permanent part of the tax code. The Coalition appreciates the opportunity to submit this written statement as the Senate Finance Committee considers various education and training tax proposals.

Section 127 allows workers to exclude up to $5,250 a year in reimbursements or direct payments for tuition, fees, and books for certain courses. Section 127 was last extended, retroactively, for the period January 1, 1995 to July 1, 1997 in the Small Business Job Protection Act of 1996 (P.L. 104-188). After July 1, 1996, however, graduate courses can no longer be excluded from taxable income under section 127. S. 127 has been introduced in the 105th Congress by Senators Daniel Patrick Moynihan (D-NY) and Chairman William V. Roth Jr. (R-DE) and enjoys broad bipartisan support. This legislation would make section 127 a permanent part of the tax code and reinstate section 127 retroactively back to July 1, 1996 for graduate courses. The coalition applauds Chairman Roth and Senator Moynihan for their leadership in the effort to make section 127 a permanent part of our tax laws. We would also note that S. 1, introduced by Senator Paul Coverdell (R-GA) would make section 127 permanent and retroactively restore graduate courses. President Clinton's Fiscal Year 1998 budget proposal to Congress also contains an extension of section 127 through December 31, 2000 for both undergraduate and graduate courses.

Congressional action making section 127 a permanent part of the tax code would remove the uncertainty and ambiguity that employees and employers now regularly face, and would be consistent with the intent of Congress when the provision was first enacted in 1978. At that time, supporters of employer-provided educational assistance hoped that the enactment of the provision would meet three broad goals: (1) reduce the complexity of the tax code; (2) reduce possible inequities among taxpayers; and (3) remove disincentives to upward mobility. Several studies have been conducted on section 127 reviewing the application, use, and effectiveness of the benefits. The two most recent studies on employer-provided educational assistance include a 1995 study conducted by the National Association of Independent Colleges and Universities (NAICU), entitled "Who Benefits from Section 127," and a Government Accounting Office study completed in December of 1996 entitled, "Tax Expenditures: Information on Employer-Provided Educational Assistance". Review of the information contained in these studies clearly demonstrates that the provision is meeting the original intent of Congress.

*Reduce the Complexity of the Tax Code*—Prior to 1978, only educational assistance provided by an employer to an employee that related to the individual's job was excluded from an employee's gross taxable income (sections 62 and 132 of the Internal Revenue Code). The "job-related" test contained in Treasury Regulation 1.162-5 was confusing to both employers and employees and resulted in both the Internal Revenue Service and the courts making arbitrary decisions as to what type of employer-provided educational assistance successfully met the test of job-relatedness. Unlike other code sections that govern educational assistance, section 127 does not require either an employer or employee to make a distinction between job-related and non-job related educational assistance in order for the employee to receive the assistance. Section 127 therefore ensures that administrative complexity is reduced and clarity is achieved for both the employer and employee. If Congress fails to reinstate section 127, employers and employees again will be faced with the difficult task of determining

whether educational assistance meets the "job-relatedness" test. As a result, the balance and equity among taxpayers that has been established through section 127 would be eliminated and the opportunities for less-educated and skilled employees to improve their skills with additional training would be restricted significantly.

*Reduce Possible Inequities Among Taxpayers*—This goal was especially important to Congressional sponsors of section 127. Under the job-related test of sections 62 and 132, most entry-level employees are unable to claim an exclusion for an educational expense because their job descriptions and responsibilities are not broad enough to meet the test. In effect, only highly skilled individuals are able to use job-related educational assistance. The goal of section 127 is to allow employees in lower-skilled positions the opportunity to receive educational assistance from their employer and for these individuals to utilize the benefit without the worry of the job-related test. According to the NAICU study, 43.6% of section 127 beneficiaries were in clerical or secretarial positions.

Like any other benefit, employers are not required to provide section 127 benefits to their employees. If an employer chooses to provide educational assistance benefits to its employees, the employer must offer the benefits to all employees on a nondiscriminatory basis that does not favor the highly compensated. This requirement, together with information from various studies, indicates that lower-skilled individuals are utilizing the benefit at a greater rate than those in more skill-intensive professions.

*Remove Disincentives to Upward Mobility*—While section 127 provides the opportunity for individuals to advance, it does not guarantee it. Recipients of section 127 are not traditional students: they are working, most of them in a full-time capacity. They choose to return to school on a part-time basis to improve their skills and educational qualifications. Without their employer's assistance, many of these individuals would not be able to pay for the education themselves. Each time the provision expires and employers begin to withhold taxes on the benefit, individuals relying on section 127 discontinue or scale back their undergraduate and graduate educational pursuits because they cannot afford to even pay the taxes on the benefit. According to the NAICU study, 33 percent of section 127 recipients were pursuing associate degrees, 23 percent were in bachelor's degree programs, and 13 percent were enrolled in programs that awarded undergraduate educational certificates. According to this same study, nearly 85 percent of section 127 recipients earned less than $50,000 and 50 percent of the recipients earned less than $32,000. Clearly those who section 127 was intended to benefit are using this opportunity to upgrade their skills, keep current in this rapidly changing technological environment, and potentially advance within their organization.

As Congress debates the role of the federal government in education, there are some important points to consider when contemplating a permanent extension of section 127:

*Section 127 is Not a Government Program*—This is a purely private sector initiative and the most significant provision encouraging employer investment in their worker's continuing education. There is no large bureaucracy to administer the program. Like any other benefit, employers are not required to provide section 127 benefits to their employees. Nevertheless, employers provide these benefits to their employees because they see value and a return on the investment in their employees' education. Employees use section 127 benefits to keep current with changing trends in rapidly advancing fields as well as to improve basic skills.

*Section 127 Encourages Business Support and Partnership of Education Initiatives*—This provision is a good proposal for employers and employees alike, encouraging partnerships between a company and its individual employees. Companies see section 127 benefits as a prudent and an economically sound investment in its workforce because they receive, in return, a better educated and more technically skilled worker. Employees view section 127 as a way to improve their work skills and advance up the ladder of success. These benefits also provide companies with additional flexibility when conducting a reengineering or downsizing effort since educational assistance may be

offered through an outreach program to their laid-off workers or be used to retrain employees for other positions.

Moreover, a recent survey of economists suggests that additional funding for education as well as research and development are the most significant policies needed to boost the wages of lower-paid workers and increase the long-term economic growth rate.

The Coalition applauds the bipartisan efforts to make section 127 permanent. The Small Business Job Protection Act reinstated section 127, the eighth time that the provision has been extended since it was first enacted as part of the Revenue Act of 1978. Every extension of section 127 has been retroactive. The on-again, off-again extension of section 127 causes uncertainty in the tax code, creates administrative difficulties for employers, corrodes our system of voluntary compliance with the tax laws, and leaves employees with unanticipated tax liabilities.

The continued education and development of the U.S. worker are fundamental to meeting the challenges of the international marketplace. The Coalition urges Congress to make a commitment to the continuing education of our work force by reinstating the exclusion for graduate courses and making section 127 permanent.

Thank you for this opportunity to express our support for the permanent extension of section 127.

**This statement has been endorsed by the following organizations:**

AACSB—The International Association for Management Education
American Association of Community Colleges
American Association of Engineering Societies
American Association of University Professors
American Council on Education
American Electronics Association
American Federation of State, County and Municipal Employees
American Federation of Teachers
American Institute of Chemical Engineers
American Society of Civil Engineers
American Society for Payroll Management
American Society of Association Executives
American Society for Training and Development
American Student Association of Community Colleges
Associated General Contractors of America
Association of American Universities
Association of Community College Trustees
Augsberg College
California Institute of Technology
Ceridian Corporation
College Bound
Colorado Association of Commerce and Industry
Council for Adult and Experiential Learning
Electronics Industry Association
Hewlett-Packard Company
Institute of Electrical and Electronics Engineers—United States Activities
International Personnel Management Association
Land O'Lakes Corporation
Marymount University
National Alliance for Business
National Association of College and University Business Officers
National Association of Graduate and Professional Students
National Association of Independent Colleges and Universities

**National Association of Independent Schools**
**National Association of Manufacturers**
**National Society of Professional Engineers**
**National Tooling and Machining Association**
**Northrup Grumman Corporation**
**NYNEX**
**The Johns Hopkins University**
**The McGraw-Hill Companies**
**Society for Human Resource Management**
**Sun Microsystems, Incorporated**
**Telephone and Data Systems, Inc.**
**United Technologies**
**University Continuing Education Association**
**University of Michigan**
**U.S. Chamber of Commerce**